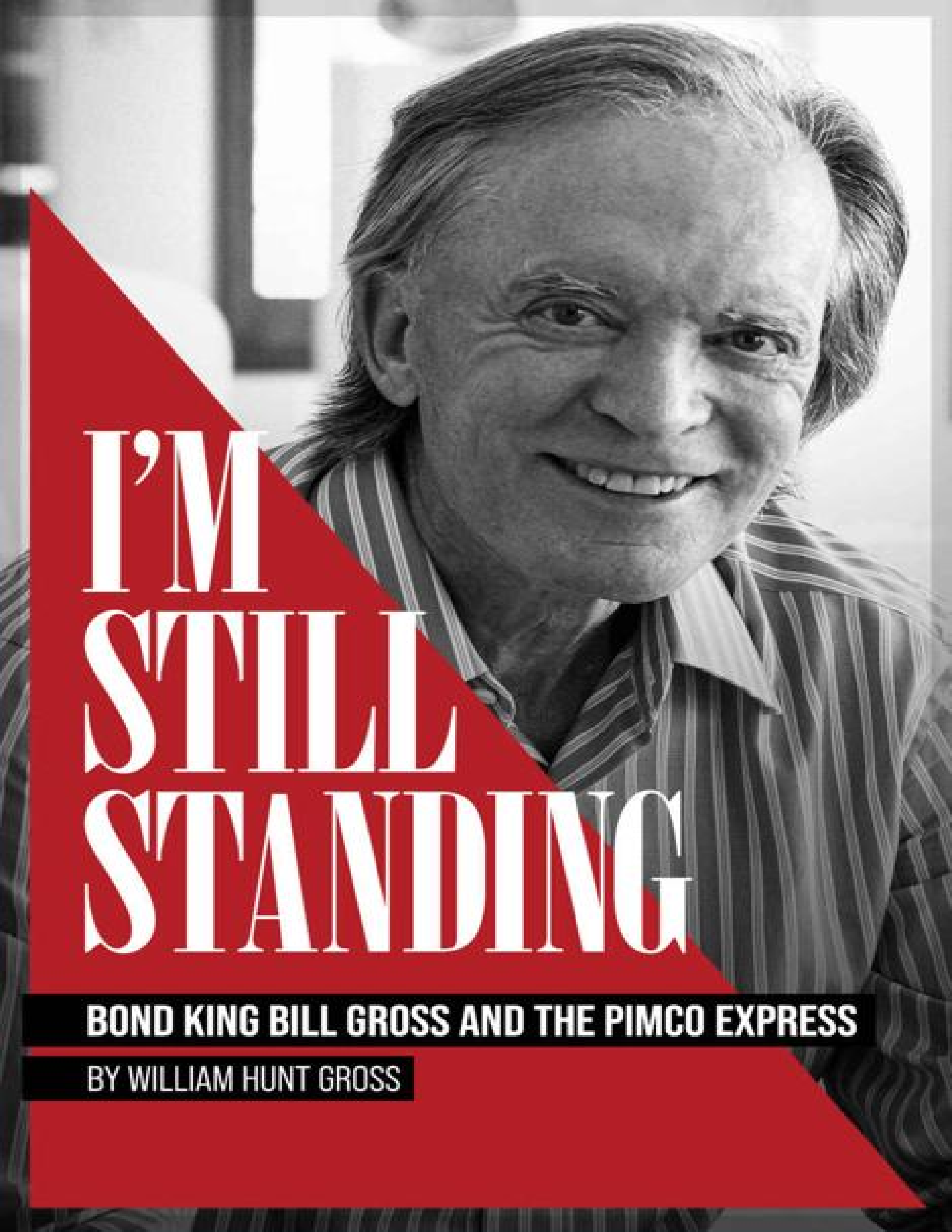

I'M STILL STANDING

BOND KING BILL GROSS AND THE PIMCO EXPRESS

BY WILLIAM HUNT GROSS

William Hunt Gross

I’m Still Standing

Bond King Bill Gross and the PIMCO Express

First published by William Hunt Gross 2022

First edition

This book was professionally typeset on Reedsy
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Talent is helpful in writing, but guts are absolutely necessary

— Jessamyn West

The time has come, ' the Walrus said,
To talk of many things:
Of shoes — and ships — and sealing-wax —
Of cabbages — and KINGS

— Lewis Carroll, “The Walrus and the Carpenter”

I am leaving, I am leaving
But the fighter still remains

— Simon & Garfunkel, “The Boxer”

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This Is My Story

This is my story. This is PIMCO’s story. The story of the world’s first and likely last “Bond King”, at one time the world’s greatest philatelist, and the luckiest pro-am golfer ever. But I go too far too soon – it’s mainly about my 43 years at and the building of PIMCO. I want to tell you how PIMCO became the largest bond manager in the world and describe our “secret sauce” that led to its incredible success. I want to describe leaving PIMCO reluctantly in September of 2014 and what’s happened since. But why now you might ask? Like they say on TV these days, “That’s a good question.” It may seem like a story told by a 19th century railroad man in the age of SpaceX and it likely is. The bond and financial markets have changed so much since my retirement in 2019 that readers may probably think my time has come and gone. And of course it has. But then it’s still a good story.

A friend of mine, when missing a putt on the golf course sometimes says, “a billion and a half Chinese don’t care.” Same case here, but for those Chinese that might be persuaded to think of me and wonder, “Whatever happened

to Bill Gross and how did PIMCO become so successful?, " it's for them that I'm writing this story. If not them, at least my kids might (might!) care.

But I also write to set the record straight. There never was a Bond King but there was a passionate leader of a bond management firm called PIMCO which dominated market performance for nearly four decades and made "more money for more people" as one investment consultant wrote "than any firm on Earth." I stood tall then and come to think of it, while my posture is now a little stooped – I'm still standing!

Let me start with a few brief pages about my personal history before we get into the juicer PIMCO stuff, and then some things about what's been happening with me and the markets since 2014. Maybe a little bit about what might happen in 2022 and beyond as well!

Let's get started. I was born in 1944, a child of Dr. Spock, a child of the Cold War. My parents were cold too, and non-huggy, but devoted to their kids and their education. In the first grade, my mom wanted to skip me from 1st to 3rd grade at our two-story, four-classroom brick schoolhouse in West Middletown, Ohio, because I had tested as having the highest IQ for a six year old in the state of Ohio. Must have been a mistake, because while I was smart, I was only close to Mensa caliber and my Duke undergraduate grades finally proved it in the early 60's. If I had a high "Q" it was a "CQ", a Mensa equivalent "common sense quotient" enhanced by

a for-years undiagnosed mild autism commonly called Asperger's syndrome.

I did not skip 1st grade, but instead the family skipped a town that was later labeled "Middletucky" in the famous book and movie "Hillbilly Elegy". My father, Sewell Gross, must have sensed the necessity for a better education because he sacrificed a blossoming career at Armco Steel to move us all to San Francisco on the California Zephyr – a bubble-glass passenger train departing Chicago and arriving in San Francisco in the summer of 1954. In the Zephyr's tiny passenger compartment we put down newspapers for our German shepherd "Budgie, " along with Mom, Dad, brother Chip, and 2-year-old sister Lynn. Luxury in transportation was to come 40 years later with a private plane!

California was much different than Middletucky. New schools, gyms, swimming pools, even, and the teachers were good, as was the class competition in the early days of Silicon valley. I did great, got an academic scholarship to Duke, tried out for the basketball team in the summer of 1962 and was cut in the first 15 minutes. I was six feet tall and endowed with speed, but only average coordination. After a great pass in high school, my high school basketball coach told me in the ensuing huddle, "Gross, if you could only shoot." So true, I couldn't shoot, but my ferocious ambition was allowed to move in a more productive directive because of it. My Duke tryout, though, was to lead to long-term friendships.

Thirty years later, Bucky Waters, the freshman coach who wisely cut me, had become a host for philanthropic guests at Duke. Reaching his hand out as he got out of his rickety Ford station wagon, he said, “Nice to meet you Bill.” I said, “Nice to meet you as well Bucky but we’ve met before. You cut me in freshman tryouts in 1962.” Whoops – it was awkward for just a few minutes. He was a wonderful man, as was his wife Dottie, and we’ve corresponded with portfolio ideas ever since.

I graduated without honors from Duke (2.8 GPA) and was about to be drafted and sent to Vietnam. My draft deferment excuse of “flat feet” was immediately rejected so I enlisted as an officer in the Navy flight program at Pensacola, Florida. After basically spending five frustrating white-knuckle months training on propeller driven T-28’s, the Admiral cut me from his team too, and sent me to Vietnam as captain of a small PT boat transporting Navy SEALs upriver in the Mekong Delta. “Mr. Gross, ” he said, “if you think you’re going to be transferred to a cushy desk job, you’ve got another think coming.” And so in a few short months I was shipped across the Pacific to an assignment more dangerous than that of a jet jockey spewing Agent Orange over the treetops. My experience there is detailed in a lengthy “Stars and Stripes” article published in July 2015.

My two years nearly matched that of Martin Sheen in “Apocalypse Now”, including the surfing and gunboat episodes, but I escaped ‘Nam safely in 1969 and went on to

the UCLA Anderson graduate school in finance, where I rediscovered Ed Thorp, and his second book, “Beat the Market”. I had first learned about him from a blackjack book called “Beat the Dealer” in 1966 and had played professional blackjack before reporting to flight school. That experience was to be the formative experience of my life because it taught me how to measure risk in the financial markets. But first a little story about how I got there and spent an incredible three months in Las Vegas at the ripe old age of 22.

Fate would have it that I ended up in a head-on collision in college while driving to pick up donuts for a fraternity rush. Instead of donuts I received a long stay in the hospital and multiple surgeries to reattach my scalp, among other extremities. To pass the time, I studied Ed Thorp’s “Beat the Dealer”, then headed to Vegas after graduating from Duke in June 1966.

My journey from Durham, North Carolina, to Las Vegas was not exactly in the luxury to which I’ve now become accustomed. I hopped a freight train, then traveled to Vegas by way of Atlanta with $200 sewed to the inside of my pants to prevent robbery. When I got to Vegas I stayed in a motel that cost $6 a night, and played the tables 16 hours a day.

As recounted in my prior book “Bill Gross on Investing”, my goal was to win some money playing blackjack without any clue that my four months at the tables in Vegas were to lay the foundation for a successful career on Wall Street, or

the West Coast version of it. What happened in Vegas didn't stay in Vegas, I learned several important principles of investing that I employed throughout my career. And I parlayed that modest bankroll of $200 into $10, 000 to pay my way through graduate school.

Although frowned upon by the casinos, professional blackjack utilizes a system of counting cards. If you know what cards are left in the deck, you can determine whether the odds are in your favor or lean toward the house. Most of the time the casino is favored, but there are times when the deck favors the player, and it's at those times that making large bets will tilt the overall long-term odds toward the player. Knowing when to place a large bet, however, is no guarantee of success, because even when the odds favor the player, they still only *lean* in his or her direction. If you are aware of that reality, it would be foolish to shove all your chips on the table for any one play of cards. Fifty-two percent of the time you might double your money. Might. But 48% of the time you'll be wiped out. Casinos thrive on that type of gambling because it typifies poor money management.

When the odds are in your favor, your bet has to be large, but not so big that it jeopardizes your bankroll, or the rent money, as the case may be, The theory is formally labeled "gambler's ruin" but it might well be called "portfolio diversification". Long before Harry Markowitz at UCLA came up with the theory of diversified risk that

eventually won him a Nobel Prize in economics, blackjack players were onto the same principle: you must not bet all your chips at the same time, because the results will be disastrous if you're wrong.

Applied to the investment arena, it means that you don't want to own just one stock, one bond or even one piece of real estate (unless it's your home and that's what you can afford). An investment portfolio should consist of an appropriate mix of stocks, bonds, and possibly real estate, or bitcoins these days. Despite the perception of many hopeful investors, stocks do not always move upward. Recent annualized stock market returns of around 10% cannot continue forever, because our economy and corporate profits can't grow that steadily that fast. There are also traumatic periods of time – recessions – that produce sharp, sudden downturns in equity prices. If all you own are stocks, be prepared to have a very long time horizon, and psychological stamina to withstand a lot of short-term and even medium-term pain when the next recession inevitably arrives.

But while Thorp's "Beat the Dealer" was formative in my later career at PIMCO, Thorp's second book "Beat the Market" which was published just as I was entering graduate school at UCLA Anderson in 1971, was equally important. It got me a job! Having read the book, which was a method of "beating the market" via convertible bonds, I used it as the basis for my master's thesis, and graduation. One month

later, I applied for a job at Pacific Mutual Life in downtown Los Angeles and was hired.

Years later my initial boss at Pac Mutual, Ben Ehlert, admitted to me that it was this thesis that got me in. “At least,” he said, “we thought you were the one candidate who did any work in college on convertible bonds or even the bond market”.

Thorp’s new book was a forerunner to the Black–Scholes option model, and came in handy later in my career with the understanding of optionality and concepts of duration and convexity. I owe my mother for that job and other things as well. She read the Pacific Mutual ad in the LA Times one Sunday morning and said, “Bill, would this interest you?” It did, even though it was for a security analyst, because at the time I had no job offers and my first baby, Jeff, was on the way.

I reported to Pacific Mutual and was partially assigned to clip bond coupons in the basement vault, but then came Howard Raykoff, a bond salesman from Weeden & Co., who informed me and my boss, Ben Ehlert, about the joys of trading bonds, just like stocks.

Back in those days, there were very few computers, only the old IBM 360’s and Pacific Mutual and Wall Street firms were lucky to own even one. Electronic trading and executions, therefore, were not yet practical. A phone on one ear and one on the other were the necessary tools of the trade and if bonds were to be bought, sold and then

settled, it was a laborious process that discouraged activity. But there was a bond trader at Occidental Insurance in Los Angeles that Raykoff informed me of. He would put his firm's bonds in a cardboard box next to his desk and send them back and forth to New York for settlement. It sounded better to me than going down to our vault a few days a week, so Ehlert agreed to my early proposal to take $5 million of Pacific Mutual's bonds and set up a trading account which would establish a performance record relative to an early Salomon Brothers bond index, and then hopefully market our expertise to small pension clients.

PIMCO was born a month later. I owe mom, Ben Ehlert, and Howard Raykoff. Ben is retired in Colorado. Howard lives in Beverly Hills now with his family, and is usually despondent about anything you can name. Not too long ago he wrote me about ticks in his bedroom and I told him to at least "don't let the bedbugs bite." I thank Howard endlessly, and he thanks me endlessly for the years' ensuing bond trades that set him up in Beverly Hills for life. Symbiosis at its finest.

Anyway, PIMCO began, but was about to be canceled by the Pacific Mutual board in its first few years because of too few clients and increasing losses. Just at the last hour, however, Congress created ERISA, a law that mandated diversity for pension funds in their employment of investment managers, including "geographical diversity". Fledgling PIMCO was obviously non-diverse, with three white

men at the core, but was fortunately located “West of the Mississippi”.

AT&T’s fund was totally invested by New York, Chicago, and Detroit banks at the time, so PIMCO was a good geographical diversity candidate for them, and I guess we impressed them, despite our early thirties youthfulness. We were hired by the largest pension fund in the world. The rest would be history.

The 80’s and 90’s flashed by quickly with much success for PIMCO and for me as well as an increasingly visible personage on Wall Street Week and with my monthly Investment Outlooks. We were also assisted by a brilliant young management consultant named Rodger Smith from Greenwich Associates in the early 80’s. Having begun the Outlooks in the late 70’s, I knew that most potential clients trashed any brokerage firms’ boring one-page forecasts and I determined to do better. My one inspiration on publicity came from my 75-year-old next-door neighbor, whom I met while cutting the front lawn. I had just been divorced from my first wife of 12 years, and because of my shyness that I later was to learn was a mild case of Asperger’s syndrome, I was striking out with regularity. “Bill, ” she asked, “how’s it going with meeting new people?” “Not so good, ” I replied. “It’s hard to meet people.” “Well Bill,” she said, “you can’t get laid unless you say hello!” So thank you neighbor! The advice was well applied on the PIMCO marketing side.

Personally, I never learned how to say hello with people and certainly not with women at bars.

So I learned to say hello from a business standpoint via a different monthly Investment Outlook than had ever been attempted. They were a little zany in the opening paragraphs but my thought was to draw the reader in and then expand on the bond market. I think some went too far, mentioning talking toilets or fat baseball umpires that lost us the umpires' association pension account. But on the whole I made a name for myself and PIMCO as well, which was the objective. One such Outlook, "Back to Butler Creek", a reflection of my 10-year childhood in Middletucky, was especially well remembered. Another, a poem by me titled "Out of Africa", about my reflections on life in a forgotten continent was memorable as well and drew lots of client letters. They and 15 others are included in this appendix.

The TV appearances began with a fortunate guest appearance in 1982 on "Wall Street Week" with Louis Rukeyser. The producer, Rich Dubroff, had seen me on a brief CNN market update and decided to take a chance on me and another relative unknown rookie by the name of Peter Lynch. Lynch was to be the expert on stocks and yours truly on bonds. Frightened to death by the prospect of answering questions from the ruler of financial TV – Louis Rukeyser – I rehearsed for four hours in the woods of Owings Mills, Maryland, before finally arriving at the appointed hour.

I never did meet Lynch, as the show was shot in two different segments, but I was later to be compared to him as the “Peter Lynch of Bonds”, which I humorously described in an Investment Outlook included in the appendix. I wanted to think he was the “Bill Gross of Stocks” but that was more ego then than reality. Now? Who knows, but 1.5 billion Chinese don’t care.

Future TV appearances came quickly – CNN, CNBC, FOX and additional Wall Street Week shows which took three business days of travel to the East Coast to ensure an appearance at 8pm EST Friday night. I was always nervous in the early years and extremely self-critical. After each appearance I would get into my car and scream in anguish at what I thought were mistakes in diction or minor stutters. Only in the last 10 years of my career would I comfortably sit in front of a camera. At first I would have to drive two hours up to NBC’s studio in Burbank and two hours back just for 45 seconds of publicity. Once, during the OJ Simpson police chase down the 405 freeway I was canceled entirely. Couldn’t figure out why!

At Wall Street Week I was eventually asked to be a rotating panelist which provided even more publicity for a West Coast bond firm called PIMCO that was gaining more and more clients. The panelists were each given a viewer’s question to answer in the middle of the program and one week I was given the task to explain America’s burgeoning budget deficit. For some reason, I talked about the deficit’s

“expansion” and illustrated it by pulling a preplanned rubber band out of my pocket and aiming it across the table directly at Rukeyser. In true showboating style I purposefully let the rubber band fly and it flew directly past Lou’s left ear – eliciting a startled but pissed-audible laugh. I thought I was a TV genius but Rukeyser thought otherwise. No one, it seems, made fun of the host of Wall Street Week. After the show, producer Rich Dubroff summarily informed me that I was fired! So long Wall Street Week. Future TV would have to be a little more conservative.

So while the publicity was differentiating us from the rest of a rather staid bond investor universe, so was our performance. The relative numbers were assisted in no small measure by a roaring bond bull market. Having peaked at nearly 15% in 1981, the 30 year bond was producing double-digit annual returns that reflected not only high yields but significant capital gains as well. While the famous “Total Return Fund” had yet to be created (1987), our investment philosophy that centered around a three to five year “secular outlook” was key in capturing these high returns for AT&T and other large pension fund clients. The term “secular’ outlook was so little understood by clients that a few of them asked what “religion” had to do with it! Not much, but it did feature forecasting interest rates over a three to five year horizon, which was blackjack-like in its time horizon of patiently waiting for opportunities over the long term. In addition, the concept of “total return” for

which I was to become well known, sought to think of bonds much like stocks which earned a dividend but were also viewed as capital gains vehicles.

PIMCO's Secular Outlook was determined once every year at its "Secular Forum" when we invited outside guests and speakers from Wall Street, and Main Street USA. Several of the names would be familiar to you, such as Alan Greenspan, Ben Bernanke, Paul Volcker, Google's Eric Schmidt, Robert Reich, and many others. There were actually very few years when we changed our three-to-five-year Secular Outlook on interest rates from bullish to even neutral. As it turns out, despite short term yield increases over 12- to 18-month time periods, PIMCO's bullish outlook proved to be a money maker for clients even though portfolios hardly ever exceed index durations by more than a year or so. The "Kelly Criterion" betting system I learned in blackjack mandated a conservatively larger bet but never one which could underperform market indices by more than 1%. We never did.

With high interest rates in the 1980's, bonds had the potential for both – yield plus capital gains – and so we invested with a keen eye toward price appreciation in a secularly declining interest rate world. Getting that longer term forecast for lower yields was key to our success and was constantly updated by daily investment management meetings which started at 12 and ended sometime around 3!. PIMCO was a bond firm – yes – but one with a belief that

we could accurately forecast interest rates over a long term time period – much like I used to forecast winning results at blackjack if I stayed at the table long enough.

In addition to the interest rate forecasting, though, a critical and constant source of "alpha", or excess return over the market, was what we called "structural alpha". This concept was illuminated by perhaps my most academic publication in The Journal of Portfolio Management in 1989. Fischer Black, the co-originator of the Black-Scholes options pricing model, had originally introduced the concept of "noise" in asset prices, meaning fluctuations in price that had little to do with fundamentals. The noise was emblematic of human emotion and was separate and distinct from what portfolios now emphasize as "momentum". "Selling the noise" the title of my 1989 article, then described several ways to produce "structural – almost always" consistent alpha that was built into the financial system by regulations and otherwise.

If there are one or two specific portfolio ideas that I slap my own back for, it's articles I wrote for The Journal of Portfolio Management and Financial Analysts Journal. Forgive me for saying this, but upon review of these two articles for inclusion in this book, I emailed my editor Seth Lubove, "Man, I've forgotten how smart I was 20 years ago!" "Consistent Alpha Generation Through Structure" for the September 2005 Financial Analysts Journal and "Selling the Noise" for the Spring 1989 issue of The Journal of

Portfolio Management were fundamental, near perpetual observations of “game playing” that allowed PIMCO to outperform competitors despite numerous mistakes in interest rate forecasting. If you read nothing else, read those two articles – they have relevance even now.

One structural alpha money maker was high-yield, one-year short term bonds that were rated BB and just below investment grade – thus preventing them from ownership by most banks, insurance companies and pension funds. The yield spread was (and remains today) excessively wide between similar maturity Baa rated issues because of regulatory mandate.

PIMCO would use these short-term “money market” equivalents to back our purchases of interest rate futures (we called these bonds “Lambda cash”), thus combining the cheapness of these “futures” contracts in the 80’s and 90’s with 1% to 2% higher yielding 12-month or shorter Ba rated bonds to in effect produce a synthetic Treasury bond yielding 2% to 3% more than those available for cash purchase. Since bond market indices contained 60% or so U.S. Treasuries, simply matching the index Treasury component would produce structural alpha in the vicinity of 1% or more per year.

Another strategy engineered by Managing Director Changhong Zhu was to use Eurodollar futures and roll down the yield curve from the 5th forward quarterly contract (1.25 years) to the 4th (one year). Industry reporting standards

mandated the same duration number for the 5th as well as the 4th contract since they were both three-month forward maturities. The 5th contract, however, yielded 20-25 basis points more than the 4th and added price appreciation to boot as it approached the value of the 4th in three months' time.

While this may be a little technical to the reader, this and the short-term, high yield strategy were typical of PIMCO's portfolio construction over many time periods no matter where interest rates headed. The Eurodollar strategy doesn't exist today due to Jerome Powell's 0% interest rate policy and it may never return again. Nevertheless, we exploited these and other strategies to produce low volatility, high return annual results that led to me (and PIMCO) to be known as the "King of Bonds, " first mentioned by Fortune magazine in the late 1990's.

PIMCO in the millennium's last decade was doing very well. Assets were $10 billion, $20 billion, $100 billion and growing. One of our long standing traditions was to ring a large bell every time we got a new client and it seemed like it was ringing every day. Portfolio management, though a focus, was not the singular reason for our success. As mentioned a few pages later, PIMCO was built from the beginning on a three-legged stool which in addition to the investment side, depended on marketing and client servicing, as well as business management. PIMCO would not have been PIMCO without Jim Muzzy and Bill Podlich –

both brilliant in their respective areas of marketing (Muzzy) and planning (Podlich). Muzzy – five years older than yours truly would help PIMCO thrive until 2009 and Podlich – one year younger than I – would choose an early exit in the mid 90's to enjoy family and railroad trains, of all things.

Jim Muzzy and I spent hours/weeks/years traveling together on the road in search of new clients and our success ratio was well over 50%. The "Muzz" would warm up the audience and I would close with strategy and forecasts. But we had some interesting times together before and after the meetings. Jim was the heart and soul of keeping expenses low although Dean Meiling – our fifth partner — took first place with his edict that all employees should save and recycle paper clips. Jim though took pride in staying at the cheapest motels/hotels. One time in New York City when three of us were presenting, we all shared the same $125 room and had to flip a coin for who would sleep on the floor. I wasn't the loser, but then toe to toe with Jim was not my idea of even frugal business travel. Another motel in Connecticut came at $55 and was furnished with a "gel" bed, overhead mirrors and rather exciting wallpaper. We could hear the trucks roll in and out of the parking lot all night.

Podlich was replaced by Bill Thompson, who was managing the Salomon Brothers office in San Francisco in 1994. Thompson, our second CEO after Podlich, presided over PIMCO's quickest growth period from 1995 until 2012.

Assets increased from $100 billion to nearly $1 trillion before the financial crises of 2009. He was a people's man extraordinaire, serving up hot dogs for all on his July birthday and helping to keep my testosterone in check when needed. He thought I was funny in our private moments and during my more serious public moments he was a moderating influence. We became good friends at the office and on the golf course, even traveling to the AT&T Pebble Beach Pro-Am together.

Our first trip to the AT&T in 2003 was perhaps the most remarkable. The amateur prize had been and still remains to make the top 10% of amateur/pro team scores after three days of play come Saturday afternoon. Veteran amateur players had told Thompson and I that 18 under par for the team score usually made the cut, but my pro partner Kevin Sutherland and I had finished 16 under. Bill (14 under) met me at the 18th green and said: "Let's go home we aren't in the top 10%." I reluctantly agreed and we headed for the airport. While in line for check-in, Ron Maggard – a friend from our local club in Newport Beach – came up to me and told me that my 16 under indeed might qualify – that my team was tied for the one remaining spot which would be determined later that night. I was forced to say goodbye to Bill and checked back into the hotel.

At 9 pm that night my caddy – a rather scruffy veteran named "The Rock" – called my room and said, "Mr. Gross we made the cut". "Great, " I replied whence he continued,

“And guess who we’re partnered with at 8:30 tomorrow morning on the 1st tee?” “Who’s that” “TIGER” he shouted and I almost fell over. Playing with Tiger Woods on Sunday, as was playing with Phil Mickelson five years later in the last group on Sunday, was an amateur’s dream come true. I am indeed the luckiest (not the best) pro-am golf player ever. But to think that unless I had not accidentally met Ron Maggard at the Monterey Airport and returned back to my hotel is the golf story of my career; I would have been waking up on Sunday morning in Newport Beach while Tiger was being stood up by a rank amateur at 8:30. Unbelievable!

PIMCO’s People

But besides Thompson and Muzzy, there were now hundreds of professionals in offices other than Newport Beach. Bill Thompson had truly taken PIMCO global with New York, London, Tokyo, and Munich forming the family. And we were managing global bonds – ”Bunds” we joked – as well as domestic paper. One of the keys to PIMCO’s success was our ability to investigate and endorse (in some cases) new products as the investment markets developed.

Chris Dialynas, who joined in 1980, was a key supporter of financial futures in the mid-1980’s and served as my co-pilot until my 2014 dismissal. Chris was a professional baseball player wannabe who saw more dollar signs at PIMCO than with the Anaheim Angels. He joined the trading desk, such as it was, in the early 80’s and was more “badass” than yours truly when it came to dealing with brokers. When confronted with an impasse on price, Chris would frequently say, “You’re between a rock and a hard place buddy and I’m the hard place. I’m not movin’!” Chris would inevitably win the argument! We would share a large bag of M&M’s every morning and the sugar high that came

out of it would rocket us to the moon much more than the cocaine featured in movies such as “The Wolf of Wall Street” and other stereotypical flicks about the industry in those days.

Chris was also instrumental in generating one of the key PIMCO trades in the early 80’s. After traveling to Chicago to visit the CME and its initial attempt to market interest rate futures, Chris learned about an early contract called the GNMA CDR which professed to allow traders to hedge their mortgage portfolios. The CDR, however, was flawed and after investigation, we determined that it was structured to allow an investor (PIMCO) the option of owning high coupon/short duration GNMA mortgages or a perpetual 8% annuity. One option made the CDR a short maturity bond, the other allowed it to be an 8% government-backed long bond. If interest rates went up, we could own the short maturity option. If they went down and below 8%, we could choose the annuity. The incredible part of the trade however, that it was only being priced as a short maturity bond. Chris and I, after consulting with legal and CEO Bill Podlich, decided to go for it.

After a few months we owned nearly $2 billion notional of this futures contract. By then interest rates were falling and the 8% perpetual coupon was dominating the contract but the CDR price hadn’t changed. We decided to take delivery of the CDR with the intention of converting it to an 8% perpetual bond. Word, however, spread amongst traders

and dealers who belatedly realized our option was working against them. We were told that at the end of our month's long buying spree, floor traders on the Chicago Board of Trade were waving white handkerchiefs in surrender. I met executives of Salomon Brothers at the LA airport a week later and negotiated an exit of all parties. Profits of $70 million went straight to client portfolios. Thanks Chris.

This propelled us on our way to investigate and endorse new financial products if cheaply priced and principal safe. In the years following our endorsement of financial futures, foreign bonds, and TIPS (inflation protected securities in the late 90's) led to wide outperformance and promoted the image of PIMCO as a conservative yet innovative bond manager. That's a hard combination I suppose but that was what PIMCO was all about. Interest rate forecasting? Sure. But innovation was key as well. There was more than one Bond King in our new offices in Newport Beach, just across from our old home at Pacific Life.

We were later joined by other trader/portfolio managers who were strange but incredibly successful in their own right. Ben Trosky – Mr. High Yield – who we nicknamed "Doobie" based on observations of his enjoying some "weed" on his way home – was one of the best. His fund received top honors and his purchases filtered their way into my portfolios that would later earn me three Morningstar "Bond Manager of the Year" awards and Manager of the Decade. He shares pieces of those trophies. So too does

Dave Edington, known forevermore at PIMCO for nailing his shoe on the door of the Partners Lounge one drunken evening to protest something that I've long forgotten. His ideas and performance with his own portfolios were exceptional.

And then there was Frank Rabinovitch, the mathematical genius who chewed and digested small pieces of paper during the trading day. We hired Frank on the basis of his multiplying 133, 768 times 643, 215 in his head (our number) before we could even check the result on a hand calculator. Frank later left PIMCO rather prematurely to put the Bible on the Internet in in its early days. And then there was John Brynjolfsson, who developed PIMCO's first of its kind TIPS portfolio into a raging success. Mark Kiesel, master of corporate bonds, was crucial to PIMCO's success and still is in 2021. Strange, brilliant minds, but an important piece of PIMCO's success along the way.

The mortgage desk, headed over the years by John Hague, Bill Powers and Scott Simon, was perhaps the most consistent "alpha" generators of any of PIMCO's specialty areas. Their funds were always in the top 90th percentile and of course my total return funds made extensive use of FNMA and FHLMC mortgages throughout their years.

Perhaps one of the least well known but most accomplished strategists on the PIMCO trading floor was Changhong Zhu, a mid-30-ish portfolio manager at Bank of America when he came to our attention. Over his 10 or so

years at PIMCO he was responsible as a partner and member of the Investment Committee for many yield curve strategies involving futures and for emphasizing the structural alpha features of Eurodollar futures. For most of his tenure, the U.S. yield curve was attractively positive, meaning that 5 year Treasuries yielding 4%, for example, could, like a caterpillar becoming a butterfly, turn into 4 year Treasuries yielding 3.8% one year later, even if interest rates themselves were unchanged. In essence, they would "roll down" the yield curve, providing not only 4% interest income but another 1% in price appreciation. This concept when applied to 15 month Eurodollar futures rolling down the curve over three months to a 12 month maturity, provided an incredible "alpha" or outperformance boost to portfolios. He suggested many more ideas, and was undoubtedly the smartest strategist PIMCO ever had. We lost an honest and loyal partner when he and his family moved back to his native China at the end of 2009 to accept a position with the country's State Administration of Foreign Exchange.

Almost all of these people departed long before my departure in 2014. Some of them like Tad Rivelle left to start their own firms like MetWest, that was to become the industry's second largest mutual fund manager, much larger than the supposed new "Bond King" Jeffrey Gundlach, with his firm DoubleLine Capital. Gundlach's performance in these last five years has been anything but deserving of the

title. If anyone is deserving, as I once mentioned in an interview, it would be Scott Minerd, the chief investment officer at Guggenheim Partners, in part because of his great long-term perspective, as well as his performance.

PIMCO developed not only its own successful path but trained and fed new ideas with new branches throughout the developing bond management industry. Each of these gentlemen should share a piece of PIMCO's Morningstar trophies.

In marketing there was Wendy Cupps, Margaret Isberg, Tammie Arnold, and John Loftus who propelled us forward. Cupps, earning close to $40 million per year in 2014 was among the highest – if not the highest – paid women in any profession in the world.

These people, as well as other brilliant young professionals including an increasing percentage of women which we pursued vigorously in hiring, helped to produce 90th-plus percentile performance throughout the decades between 1980 and 2010 and to grow assets like Kansas corn in July.

During all of this asset growth at PIMCO, as well as family growth at the Gross household (now three kids in 1989), I decided to pursue a rather odd goal of becoming the greatest philatelist (stamp collector) in history. I was introduced to U.S. stamps by my mom when I was 10, that were soon forgotten due to other priorities – basketball and girls. But later on in my 40's, and with an increasing bank

account, I remembered mom having collected 100 sheet commemorative U.S. stamps during WWII. When I was 17, she showed me boxes of stamps weighing 50 pounds that she had hoped would appreciate with inflation and pay for my college tuition. She told me to take the stamps on the local train to San Francisco and sell them to one of four stamp dealers. This was a story much like “Jack and the Beanstalk” with stamps substituting for Jack’s magic beans.

Unlike Jack’s beans though, there was no golden egg to be had. Rather than appreciating over the years, the four dealers basically told me they were worthless – no bid. I took the stamps home and got an academic scholarship to Duke instead, but in my 40’s I realized that stamps were a valid although thinly held asset class. I decided to validate my mom’s intentions but to buy rare 19th century stamps, not commemorative sheets from the 1940’s. The interesting tidbit from this story is that in buying the rare stamps, I applied historical inflation and GDP growth numbers that I was using at PIMCO to find stamps that were cheaply valued. Fifteen years later in 2009, I was awarded the ASCAT Grand Prix, one of the most prestigious international awards for stamp collecting, and have since read articles and reviews that my collection was among the finest ever. I have since sold or auctioned most of it and donated all the proceeds ($50 million) to charity.

Seems like there was a golden egg there but it had been hidden underneath boxes of worthless 3 cent

commemorative stamps that my mom, with good heart but little expertise, had purchased for my future education.

Incredible Profits

But back to PIMCO. In the years after the 2007-2008 financial crisis, when assets doubled from $1 trillion to $2 trillion, PIMCO was not only one of the largest financial institutions in the world (bigger than JP Morgan, Goldman Sachs, and any others you care to name), but probably the most profitable <u>per person ever</u>. Whereas bank of America had 150,000 to 200,000 employees, PIMCO had only 1,500 to 2,000. PIMCO had not only more assets but near equal net profit margins (45 basis point fees) than BofA, but only 1% of the workforce. At the end of 2014, I was making a scaled-back 20% of profits, or $300 million, and our executive assistants were paid upwards of a half a million dollars a year as well. We didn't know how to get rid of it all.

I and CEO Bill Thompson knew, though, that $300 million versus $500,000 was a ridiculous spread, and that these differences would likely cause increasing friction. It eventually led to my reluctant departure, because while greed is sometimes good, it can raise the pirate's flag for no other reason than "me vs you" over money.

I, Bill Podlich, Bill Thompson, and “the Muzzy” had always tried to promote the concept of a PIMCO family, but no family we figured could survive these large differences between fellow employees. Therefore in 2006 or 2007, I voluntarily called for a secret vote amongst the 50 or so partners/managing directors at the time. They each took a scrap of paper, wrote down a number for my bonus, and dropped it in a large bowl collected and counted by CEO Bill Thompson. My previous 26% cut of the profit was subsequently reduced to 20% by vote. Oh my, how could I live on that! But it settled the ship for a while until 2014 when money and power ruled, and the fairy tale ended for me and others as well.

As an interesting historical fact, PIMCO in its early years (before there became too many partners to vote individually) always had an annual review in front of each other. There was never one boss (certainly not me) when it came to executive decisions. Decisions were always committee decisions, and enforced by this one person/one vote annual bonus put into effect to promote corporate democracy. My idea as I proudly remember.

PIMCO in my view remained democratic until the 2014 dispute because of this early tradition. As the numbers got too large for 50 partners to vote on each other, the annual decisions were made by a five-person compensation committee which continued to vote on themselves and the other four as well. This democratic compensation system

was key to the success of PIMCO and eventual peace until 2014.

To continue briefly on the same tangent, in 2002 I thought it would be a great morale builder to hire two Crystal Cruise ocean liners to take all the PIMCO employees and 120 Orange County “Teachers of the Year” winners to Alaska. The cost (to me) was $8 million, but it was well worth it. No fights, no “man overboards” or unplanned pregnancies to my knowledge. The memories are still with this 2003 PIMCO family and the teachers of our wonderful cruise. I and my longtime friend and PR overseer Mark Porterfield – a trusted advisor who made invaluable creative contributions to establishing the PIMCO brand while helping to get my Investment Outlooks out the door — also started the PIMCO Foundation, mandating that all partners contribute 2% of their bonus to philanthropy. I thought it should have been 5% but even so, it caused an uproar amongst partners, with some of them offering their “faux” resignations! As if! Where else could they make $10 million minus 2%!

Allianz Acquisition

Late in the 1990's, a few of the older partners (Thompson, Jim Muzzy and myself) started to think about equitizing our profit pool. While we owned shares in a closed end fund that in turn owned a piece of PIMCO, it was small. Our main source of wealth came from an increasing stream of profits that all partners had to relinquish upon retirement. We hired a few investment bankers, one of whom was a gentleman named Ken Poovey who eventually was to be the founder of our feast via strategic ideas that in effect, skinned the German insurance company Allianz alive. PIMCO, Pacific Mutual (1/2 owner) and Allianz went through the courting ritual in 1999. We entertained them in Newport Beach, they hosted us in Munich – and it seemed like a great fit – both from the standpoint of equitization as well as future growth. We viewed them and their European offices as an incredible opportunity to manage both U.S. and global assets. Even today, Allianz contributes hundreds of billions of assets to PIMCO's management portfolios, portfolios that upon my departure in 2014 totaled $2 trillion, yet several months after were cut to $1.5 trillion due to client

dissatisfaction with my leaving. In those few months I guess I might have been worth that 20% share of profits and even 5% more! (Not really – none of us were worth what we were paid.)

Still, there was constant bickering over price before the merger/acquisition, as could be expected. Ken Poovey, though, convinced Allianz that it was important to incentivize the current and future partners by in effect offering an additional bonus consisting of phantom stock that would be awarded in 10 future annual payouts based upon PIMCO's bond returns relative to competitors. They wanted to make sure that what we had accomplished <u>before</u>, in terms of the 100-200 basis point excess annual returns, would continue, and that this logically would lead to asset and profit growth for them – which upon agreement — would be 66% of profits over the next decade. Fine with us we thought. Not only were we receiving hundreds of millions at closing but a 10-year, 33% of profits annuity going forward. That annuity would turn out to be a goldmine for PIMCO! Poovey had convinced Allianz that our annuity should be treated as a stock and that annual payouts should be treated at a <u>multiple</u> based on performance! If our average account outperformed the market by say 50 basis points, then over 33% profit share of annual profits would be multiplied by 10, much like a stock with a 10 P/E ratio. If it outperformed by more, then a multiple of 12, then up to a maximum P/E of 16.

My goodness! Poovey had skinned them alive which would cripple Allianz profits for years to come. Their stock dropped from 350 to 50 over the next two years! Shortly thereafter, as the annual bonuses rolled in, I was anointed one of Forbes' 500 richest people. Even after paying Federal and California income taxes at a high near-50% total rate, I was able to accumulate billions and to fund a foundation that for now is one of the top 100 in the world. Thank you Ken Poovey. We cut him and many others into a share of this goldmine but it certainly wasn't enough.

Later I was to learn though that you can't give up control of a company without paying a price. The Allianz executives jokingly gave me a coffee mug upon closing of the deal that I kept on my desk until departure in 2014. It read: "You can always tell a German but you can't tell him much." They left us alone for a long while but in the last few years with the Mohamed El-Erian debacle, they intervened and it cost them and PIMCO $500 billion in assets, and me my job. I had told Michael Diekmann (the Allianz CEO at the time who mysteriously "resigned" a few months after the debacle in September 2014) during a joint meeting over future bonuses, to "F*** OFF". I wanted to show that we were in control and we were the alphas at the table.

"No one speaks to me like that" he said and a few months later I was gone. At 72 years of age, I suspected I wasn't indispensable, but it was the "F*** OFF" along with other issues that sealed my fate. Guess he wasn't

indispensable either! I don’t think he resigned voluntarily, if you know what I mean. Firing Gross the way they did was costly to Allianz and to him.

Financial Crisis

A topnotch investment management firm appreciates the benefits and dangers of debt and financial leverage. An old financial quote from the 19th century warns that, “He that spends what isn’t his’n must pay his debts or go to prison.” Such was the case in the early 21st century as cheap money provided by the Fed and the abolishment of Glass-Steagall Act regulations, just prior to the new millennium, led to excessive borrowing and a near blowup of modern capitalism. PIMCO’s Paul McCulley had long been a student of the writings of Hyman Minsky who warned that capitalism had inherent dangers in its structure by allowing potential extreme mismatches between the duration or maturity of debt and equity financing and the use of leverage. Paul taught this to the Investment Committee and me and warned much more strongly that Alan Greenspan had in 1996, about the irrational exuberance of markets in 2004 to 2007. Our committee caught these excesses and began to shed housing-related subprime mortgages and levered CDOs and CDX’s well before the crash.

One of the wisest decisions we ever made was to turn 10 of our credit analysts into potential (but fake) homebuyers throughout the country, to see the treacherous undergrowth of mortgage financing. My brother-in-law Jeff Stubban, who was a subprime broker, alerted me to “liar loans” and “no docs” as well. Believe me, the Fed had little clue as to what was going on, but we sensed the danger and our clients benefited enormously. We voided our portfolio of most subprime mortgages and bought mainly high-quality corporate debt and Treasuries.

PIMCO and I as its CIO got the credit, but the lightbulb was turned on by McCulley. The New York Times wrote a sensational piece about me in its Sunday edition in 2009 saying, “Treasury’s got Bill Gross on speed dial.” It labeled me as one of the nation’s most influential financiers complete with quotes from Alan Greenspan and stories about Treasury Secretary Timothy Geithner calling me on a Sunday evening on my wife’s cell phone, because I didn’t own one. The Sunday call was true. What the article didn’t write was the cellphone rang after I had consumed a few beers. The alcohol calmed me down I guess, but I’m not so sure about the advice.

I thought then, and still do now, that this was the pinnacle of my career. In interviews with prospective employees, I always asked them what they preferred: “money, power or fame”? Most dodged the question, but my choice had always been “fame”. I was now becoming

famous! Little did I think at the time that fame could turn into infamy in a flash — like it did in 2014, and with my subsequent divorce, as well as a loud music “Gilligan’s Island” lawsuit in 2020. But the firm prospered from the crisis, had positive returns over and above the competition, and subsequently doubled assets in the ensuing years. Our clients won, PIMCO won, I won. It was a triple header.

We got financial assignments from the Treasury to manage commercial paper and buy government-backed mortgages. At about the same time I and Warren Buffett, who I had met years before, even collaborated on a subprime bailout for $1 trillion that was ultimately turned down by Congress when they bailed out the banks via purchases of preferred stock instead. It was quite a few year’s ride for PIMCO, me, and to be fair, Mohamed El-Erian, who was serving as co-CIO and co-CEO, Mohamed had returned to PIMCO from Harvard and had unfortunately, as it later turned out, convinced the then-CEO Bill Thompson and I to let him become co-CIO *and* co-CEO, a decision that Thompson and I would later admit was the worst decision of our corporate lives.

His personality ultimately clashed with Thompson’s and mine, and led to Thompson’s early retirement, and my later dismissal in September of 2014. While Thompson and I had hired Mohamed as a potential replacement for me, he seemed to us to be aspiring to control the entire company,

via titles of Co-CEO and Co-CIO, and control of the Investment Committee.

Leaving Reluctantly

Now in 2021 I and others are approaching the "one billion Chinese don't care" conclusion, but for those of you who would prefer a brief summary of my firing by PIMCO in 2014 let me offer the following:

As in any conflict there are a number of factors that lead to an outcome. In my case, PIMCO and I have a number of versions of the turbulent year of 2014. Let me present a hopefully balanced view of each side's position.

1. PIMCO had frequently "requested" as early as 2012 that I present to the Executive Committee a time plan for my succession. While I thought I had done that by hiring Mohamed El-Erian who a few years later resigned for rather mysterious reasons, I then made it obvious that I was prepared to resign but favored Mihir Worah as opposed to Dan Ivascyn who was making PIMCO hundreds of millions of dollars with riskier hedge fund-like products instead of my favorite "total return" portfolios at much lower fees. PIMCO, I presume, thought I might never leave, and Ivascyn wanted to be the next King.

2. After Mohamed's resignation, proof from PIMCO's legal department showed that insiders were undermining me in the press by saying that Mohamed's resignation was due to me and the conflict Mohamed and I were having in terms of what our Investment Committee should be focused on (Mohamed's hedge products or my total return historical concept). My pursuit of Andrew Balls and Josh Thimons caused further unrest in the press and PIMCO's Executive Committee was concerned that it would continue. In my view, the moral implications of undermining PIMCO and me in the press were paramount. I was concerned about my reputation as well.
3. At an Executive Committee meeting a few weeks before my firing a heated discussion erupted about fees/index products/and the future outlook for risk assets. My view was much more conservative than others on the committee and caused serious behind-doors discussions in days following. My bearish/more cautious view favoring low fees and ETFs did not sit well with the others on the committee – only one of whom was a portfolio manager (Mihir Worah). The others were younger and focused on marketing and fees as opposed to asset management. It was my mistake over previous years to not balance the committee with an equal number of portfolio managers. Founding partner Bill Podlich had long warned about this. When the question

of my continuing employment was put to a vote, I had only one member who endorsed my view. I needed two.

4. Despite agreement from CEO Michael Diekmann to allow me to continue to manage smaller accounts and closed-end funds, PIMCO turned the tables one week before firing me and refused to allow me to do so — in fact to even maintain an office in the same building! I responded that their monetary offer was a bone even a dog wouldn't pick up.
5. Allianz and CEO Michael Diekmann may have played a significant part in the decision making. I had offended Diekmann by telling hjm to "f***" off during an executive meeting. Three months later, after PIMCO's portfolio was cut by $500 billion due in part to media reports of my leaving, they might have had their regrets.
6. Splitting up my $250 million annual bonus amongst executives as well as other influential managing directors was likely a very tasty reward for what they considered to be an excellent long term business decision.

Those previous paragraphs are (I think) rather objective conclusions of the dispute. I was going to be fired on Friday afternoon Sept 14th. I felt on the 13th unwilling to concede to a company that had moved in another direction in a rather roguish way. I would not walk their plank!

Off the PIMCO Express

In the last few months of 2014 I was in my Janus office, not two blocks from PIMCO's new fortress and, coincidentally, identical to where I had worked on my last day in mid-September. It was on the 6th floor and not the 20th, but the view was ironically spectacular as well. If I craned my neck up just a notch, I could see straight into my old, now deserted, office. I was to learn that within a week of my departure, the company had erased every vestige of my presence over nearly 40 years of money management. The three Morningstar "Manager of the Year" trophies were gone (awarded, by the way, to myself *and* my portfolio management team), the bell that was rung every time a new client signed up had been trashed, as well as various pictures, and historical memorabilia, honoring PIMCO with Gross's name attached. "Erase the past" became their motto.

It was even later joked around the trading floor that Gross's fingerprints were wiped clean during the midnight hours of the first week. PIMCO somehow felt jilted by my eight-hour early departure to Denver to meet my new

portfolio management team. They had wanted to fire me in the late Friday afternoon of September 14th to avoid TV and negative publicity, but I had refused to walk that proscribed pirates plank. The TV coverage was quite extensive that morning. I still have a picture of CNBC's Becky Quick, gawking in amazement at the under-scrolled announcement of my departure from PIMCO. Clients in the following months would express their amazement as well, withdrawing nearly $500 billion of assets and cutting off PIMCO's business model just below the knees by 25%. Executives, however, never saw a decline in their bonuses. My $250 million annual booty was divided up amongst them (and a few others for appearances sake) so that their bonuses grew proportionately. There was gold in that there treasure chest matey! To the victor belongs the spoils: $10 million bonuses jumped to $20 million; $25 million bonuses to $50 million.

I quite naturally was incensed by all this. The money didn't matter really, but the shame of being fired was a lot to handle in those first few following months and subsequent years. PIMCO had tried to make the public case that my performance was subpar and that it was time for Babe Ruth to hang up his cleats. Anticipating this, I kept a performance sheet of the $300 billion-plus-assets Total Return Fund on the last day of my management which showed, as always and for all accounts, the excess return, or "alpha" for various time periods going back 10 years or more. This portfolio, which closely resembled all of my other

accounts totaling nearly a trillion dollars, had outperformed the bond market for the last one month, six months, one year, and of course 10-year period of time. A solid performance by any measure.

I sense, as I write, that I'm starting to sound a little whiny — that you (if you're still reading) are like those billion Chinese that don't care about a missed putt. I get it. But I write to set the record straight, subjective as that assessment may be.

Before I move on to the Janus years and beyond, I need to write briefly about the most galling episode to me that occurred shortly after my leaving. In the few years prior to 2014, the firm had established a "Founders Room" to honor those who had been instrumental in PIMCO's early years. The room was dedicated actually in PIMCO's previous building and included, of course, Bill Podlich, Jim Muzzy and me as the "three Musketeers" that had risked their jobs to establish PIMCO as a separate business entity with a budget and a bottom line funded by Pacific Mutual.

But to me, the Founders Room was really established to honor Walter Gerken, the late chairman and Chief Executive Officer of Pacific Mutual Life Insurance Company, who had given the go-ahead (along with Ben Ehlert) to my idea of active bond management in the early 70's. Gerken was a risk taker and a mentor of mine until the last few years before his death in 2015. He was a devoted family man, and tennis and baseball aficionado, having once struck out —

according to him — George Bush in an Ivy league tussle. He was the real heart and soul behind PIMCO’s formation, and so we established the Founders Room to honor him, the original three Musketeers, as well as Chris Dialynas and Bill Thompson, despite the fact that Bill had joined PIMCO in the mid-90’s.

During the new and current building’s construction in 2013, we set up a beautiful room on the 21st floor so that employees and visitors could get a sense of PIMCO’s roots and our early heritage. Rather quickly after my departure, however, PIMCO erased any vestige of Gerken and the others. Silver-coated facial plaques were taken down, the nameplate over the door, and the brief written history of PIMCO’s early years were removed. This is what happens when a corporation tries to erase any vestige of what came before. Disappointed is not an adequate description, nor was their attempt to restore the room months later when the press got wind of what had happened.

The elimination of the Founders Room upset me so much that I decided to retaliate in any way I could. As a prior member of the compensation committee and one that always encouraged as narrow a bonus spread between partner managing directors as possible, as well as between male and female employees, I was in possession of the prior year’s bonus sheet for more than 50 managing directors. I decided that sunlight was a great disinfectant, even though formally each individual was cautioned to keep his or her

number to themselves. It was well-known that water cooler gossip spread information about compensation very quickly, but just in case there were still secrets amongst partners, I made eight copies of the bonus summary and mailed them in a “confidential only” envelope to eight random managing directors at the PIMCO address. A day later, I swear I could hear the screams from the 21st floor offices occupied by top executives. “Founders Room payback, ” I whispered to myself. Risk-taker Walter Gerken would have been smiling along with me.

My attorney Patty Glaser filed a lawsuit against PIMCO in October 2015, officially, as the complaint stated at the time, for “constructive termination, breach of contract, and breach of covenant of good faith and fair dealing.” But I knew I didn’t have much to gain except my self respect. As I said at the time, I committed to donate any recovery from the litigation to charity, including the PIMCO Foundation. I can’t say much about the confidential settlement from March 2017, but the good news is PIMCO agreed to dedicate a new “Founders Room” in our honor at their Newport Beach headquarters, and the PIMCO Foundation named me a “Director Emeritus” and established an annual “Bill Gross Award” in recognition of my “career-long dedication to the charitable endeavors that are at the heart of the Foundation’s mission.” As for any financial proceeds, let’s just say several charities benefited from some generous donations.

But before I move on to my years at Janus, let me summarize in the following few pages what led to PIMCO's success from the early 70's to (I presume) today. PIMCO is celebrating its 50-year anniversary this year (2021) and I'm proud of those years. But there are reasons why companies succeed, and why they have a "secret sauce" that others don't. Here is my subjective assessment of PIMCO's foundation for success:

PIMCO’s Secret Sauce

1. Focus on the client first – always the client first – in terms of fiduciary responsibility.
2. We created a three-legged stool of leadership: portfolio management, client/account management, and business management. Each leg was fairly autonomous, allowing individual focus and attention to the client, client portfolios, and future business planning.
3. We operated lean. Obsessive attention to low expenses and keeping meetings to a minimum. We maintained independence from owners Pacific Life and Allianz in major decision making.
4. Our performance was propelled by a long-term bull market from 1981 – 2014 when bonds were competitive with annual stock returns, especially after PIMCO’s 150 – 200 annual basis points of alpha were added on top. Ten percent per year was typical.
5. In portfolio management, we focused on the long term secular outlook, three to five years in terms of economic and interest rate forecasting, and by doing so, minimized the human emotions of fear and greed that

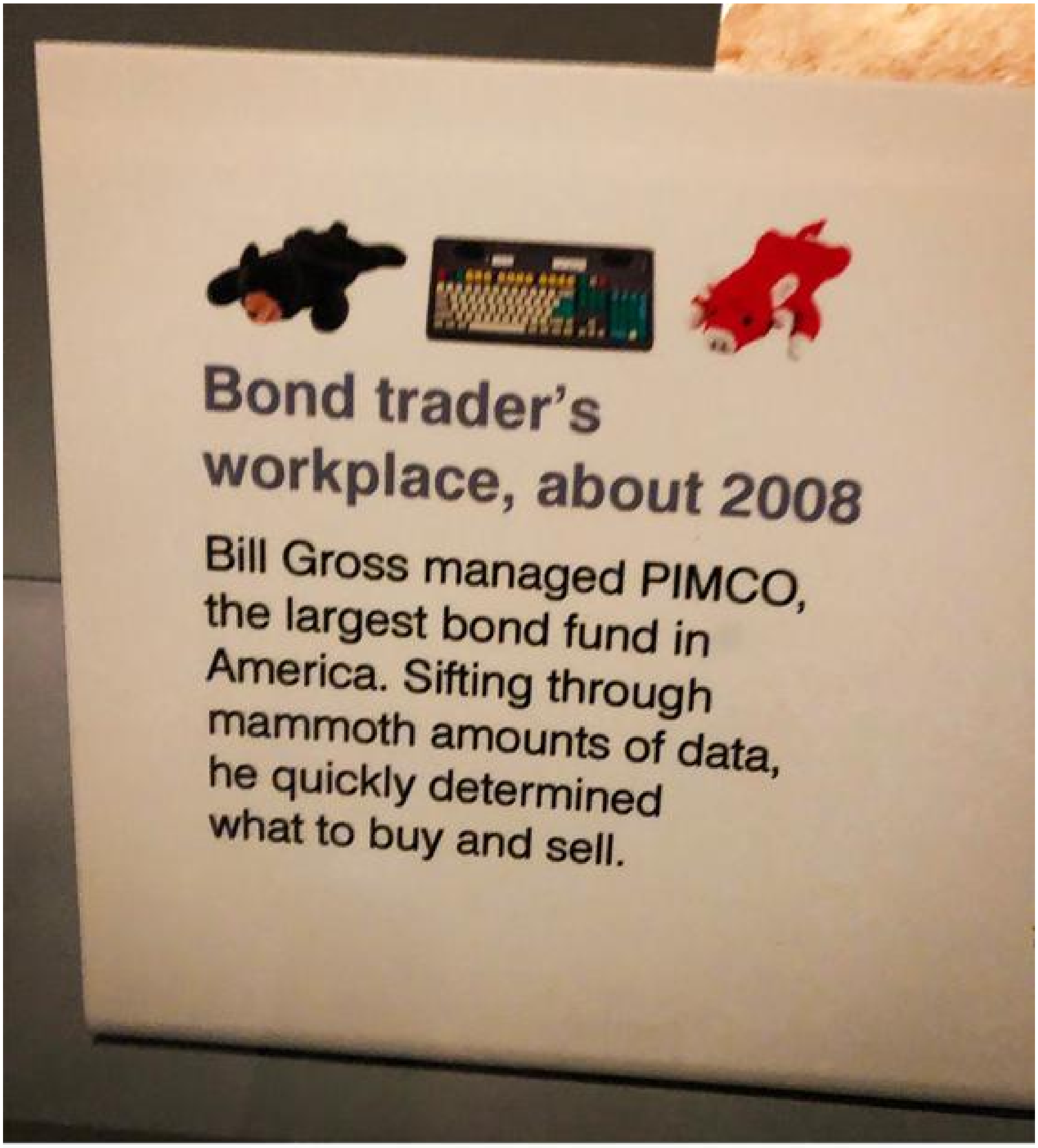
often lead to mistakes in portfolio construction. We focused on “selling the noise” and structural alpha generation for consistent outperformance.

6. In portfolio management, we fertilized the willingness to explore new product areas before the competition did. We created a first mover advantage in mortgage pass-through, financial futures, foreign bonds, and TIPS that produced significant alpha annually.
7. We hired passionate, obsessive, intelligent people to head up separate asset desks like Treasuries, corporates, junk bonds, mortgages, and TIPS.
8. We allowed for a semi-democratic form of compensation with no one person responsible for any salary or bonus. Tried to minimize meetings and excessive differences in compensation to promote high morale.
9. Yes, we promoted a publicly acknowledged “Bond King” who won multiple “Best in Business” awards in an era before “team” became the mandatory designation. Clients wanted to see the team but they also wanted to shake hands and take pictures with the “King”. A great PR move, but performance, as I’ve written here, was a team effort. Today all kings around the world are anachronisms. Central banks rule the financial markets, not Jeffrey Gundlach and his lookalikes!

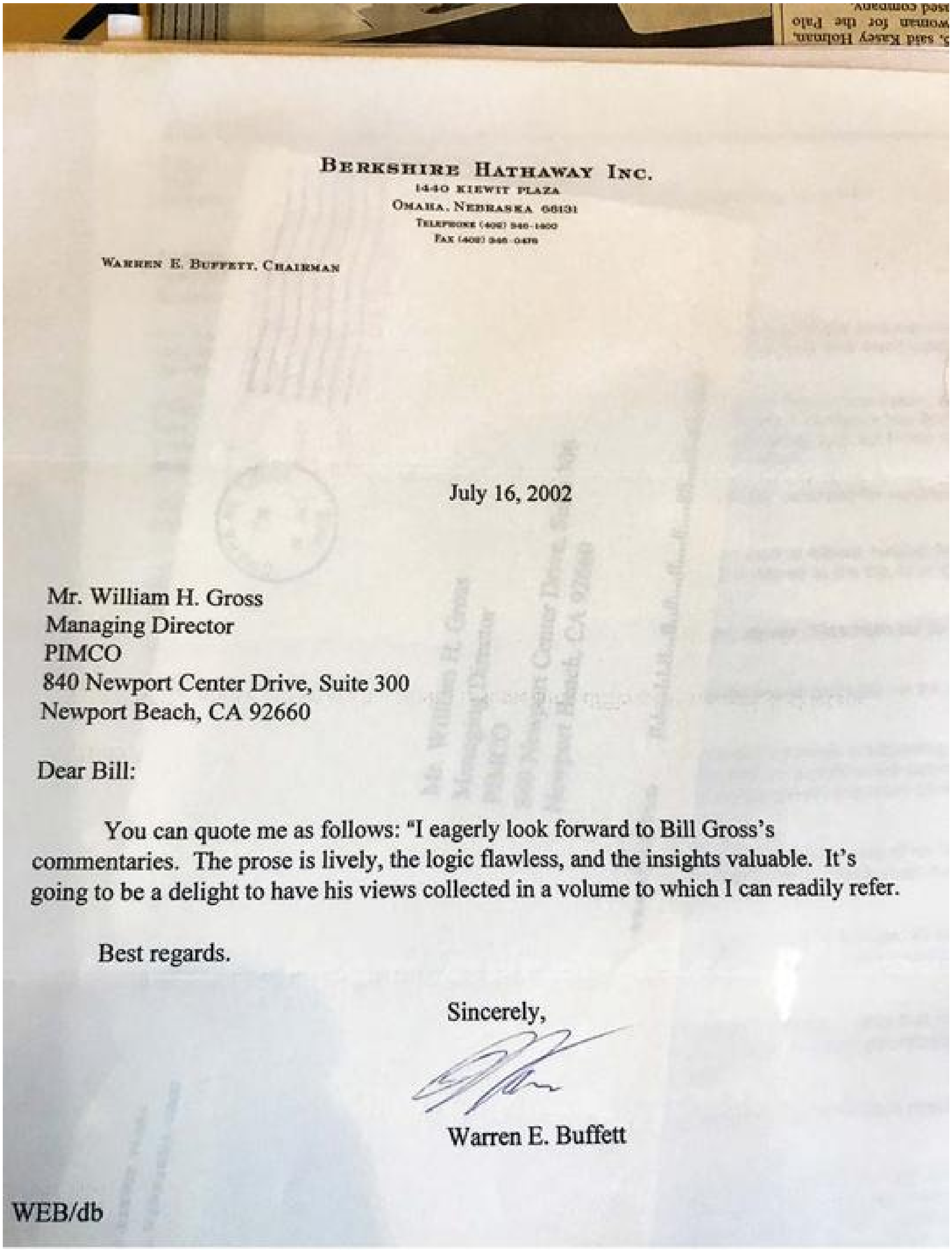
PHOTOS

In Laguna Beach.

Smithsonian exhibit featuring my old Bloomberg keyboard and other desktop knickknacks. Photo courtesy of Division of Work and Industry, National Museum of American History, Smithsonian Institution.



Description accompanying Smithsonian exhibit of my Bloomberg keyboard.



BERKSHIRE HATHAWAY INC.
1440 KIEWIT PLAZA
OMAHA, NEBRASKA 68131
TELEPHONE [illegible]
FAX [illegible]

WARREN E. BUFFETT, CHAIRMAN

July 16, 2002

Mr. William H. Gross
Managing Director
PIMCO
840 Newport Center Drive, Suite 300
Newport Beach, CA 92660

Dear Bill:

You can quote me as follows: "I eagerly look forward to Bill Gross's commentaries. The prose is lively, the logic flawless, and the insights valuable. It's going to be a delight to have his views collected in a volume to which I can readily refer.

Best regards.

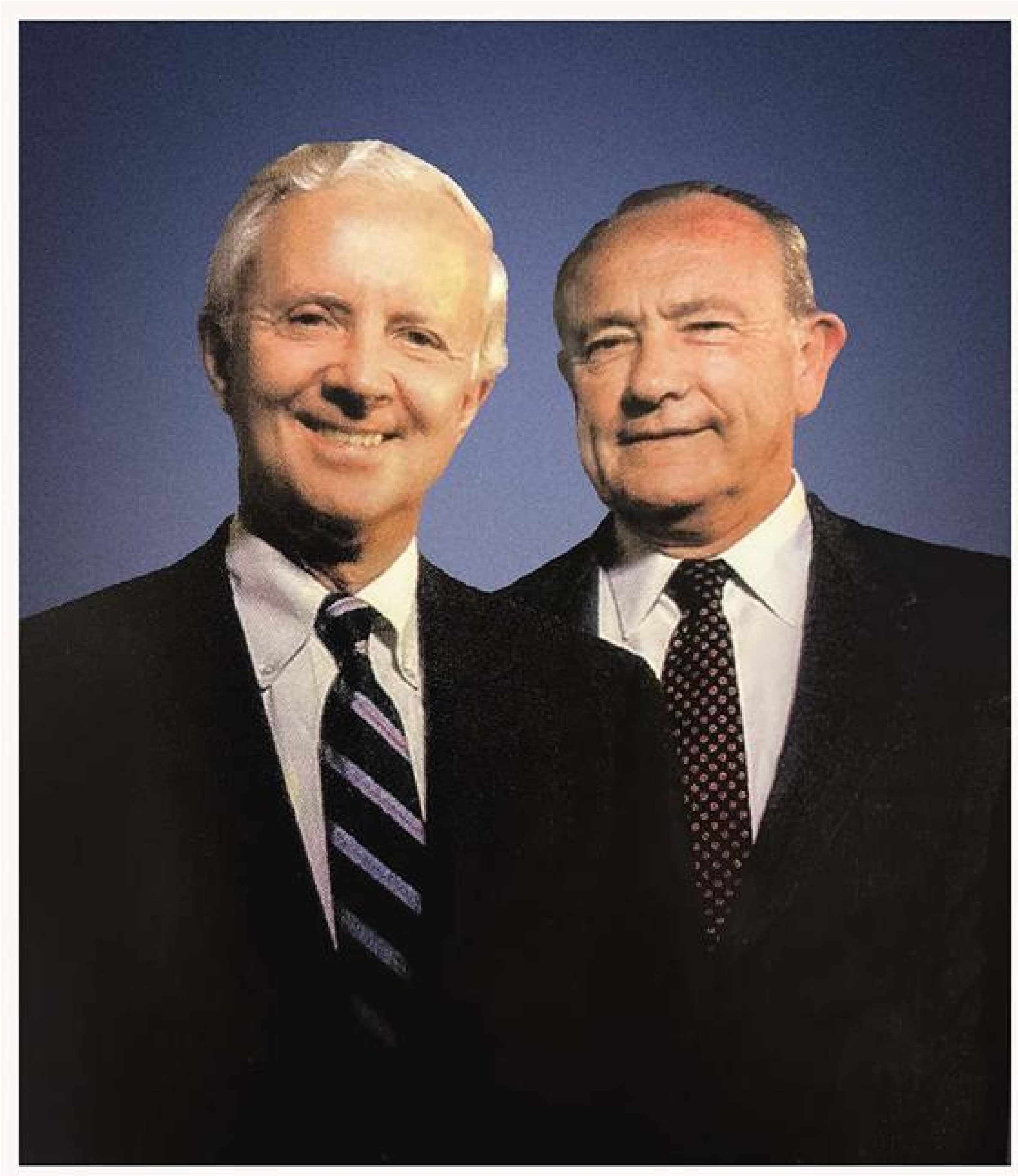
Sincerely,

Warren E. Buffett

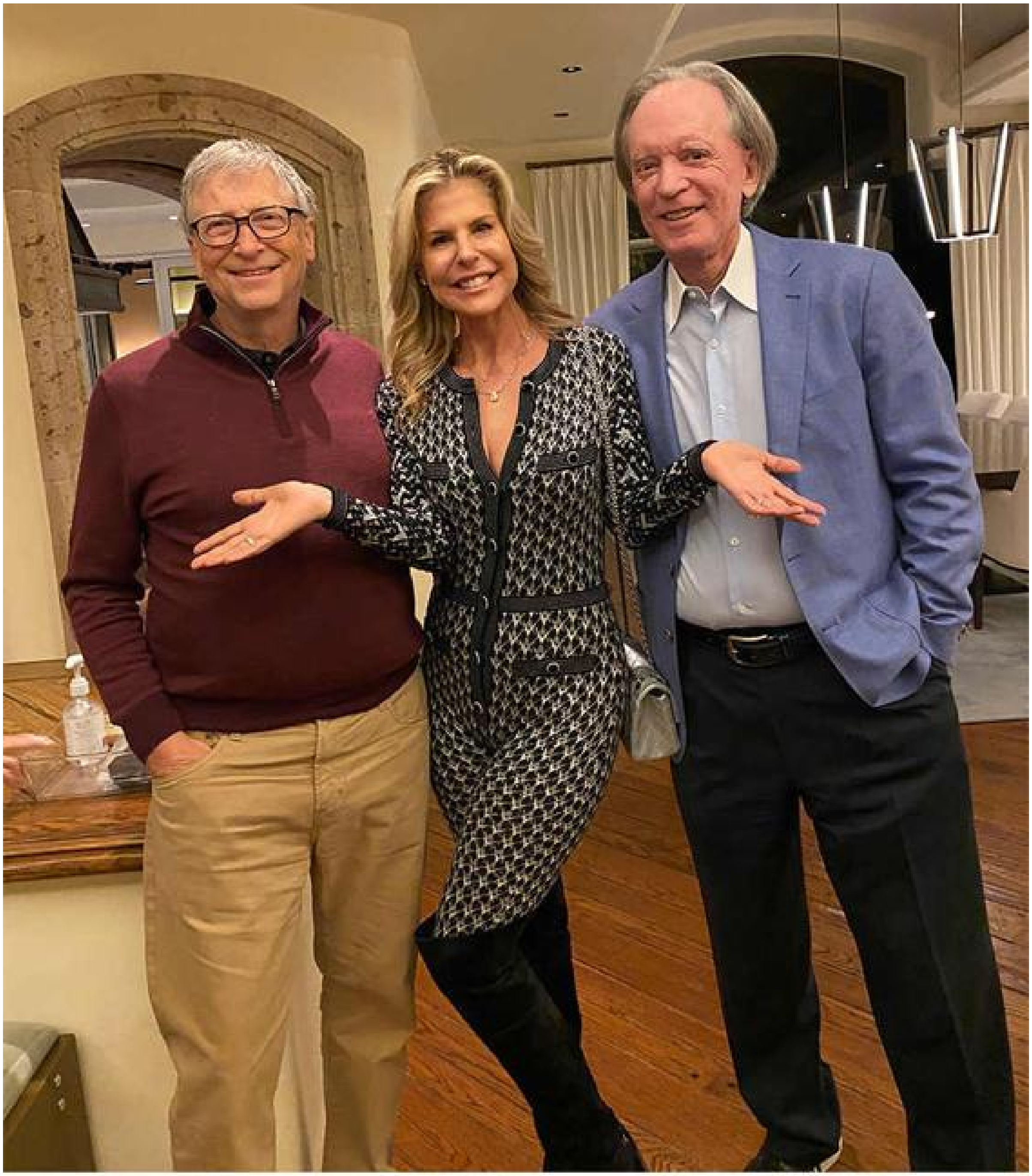
WEB/db

Letter from a fan. My Investment Outlooks were widely read.

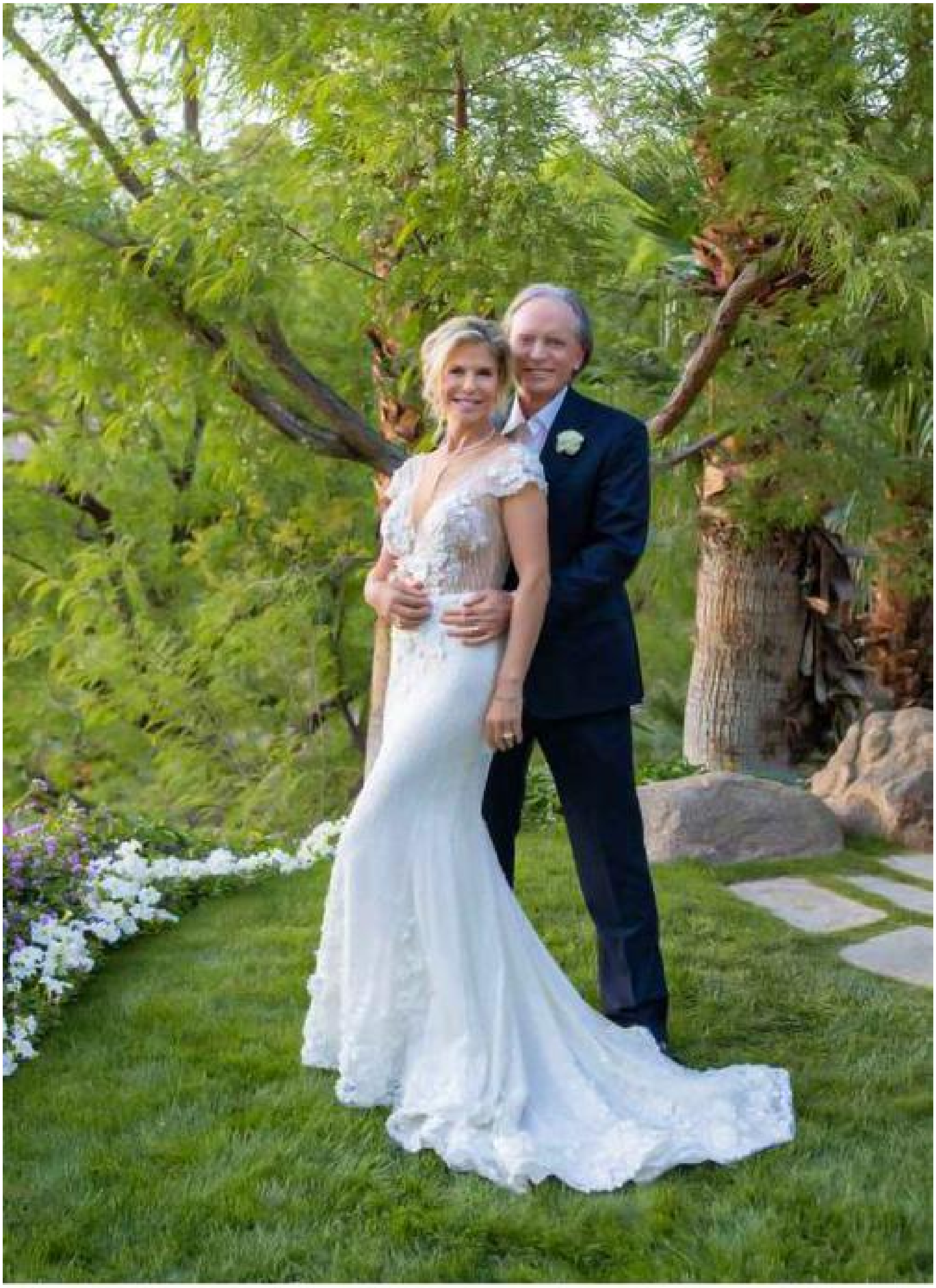
First five PIMCO managing directors, from left to right: Bill Podlich, Chris Dialynas, Jim Muzzy, Dean Meiling, and yours truly.



Walter Gerken (l) and Harry Bubb. Both CEOs of Pacific Life were instrumental in giving PIMCO leeway to grow — and sacrificing personal headlines.



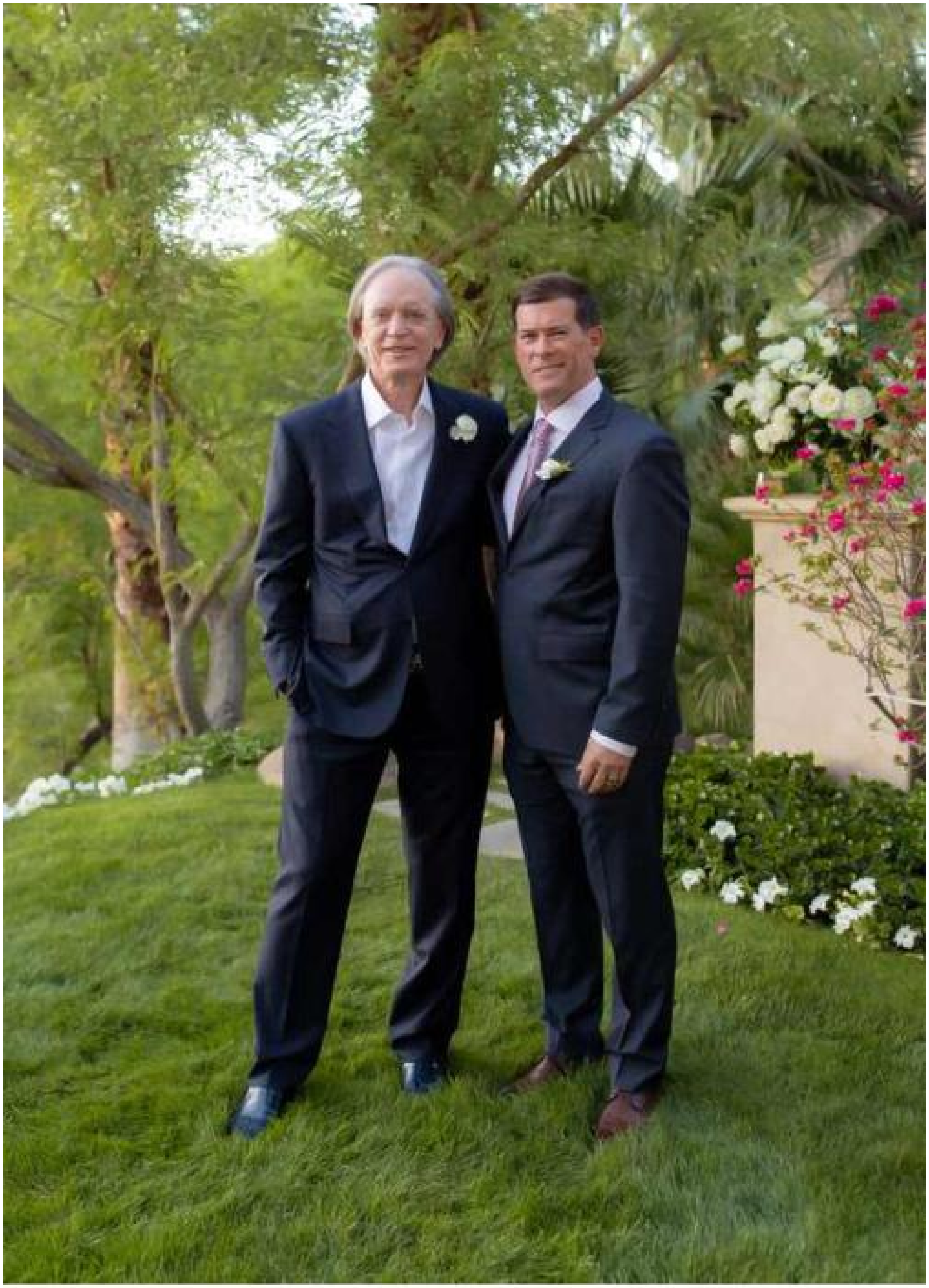
Wife Amy and a pair of Bills.



Best day ever, marriage to Amy, April 2021.

Expanded Gross clan gathers on wedding day, April 2021.

Beautiful young women: Amy with granddaughters Lila and Caroline on wedding day.



With handsome son Jeff on wedding day.

Amy with father Jay. I can see where Amy gets her good looks.

Amy and daughter-in-law Jenny doing their Talking Heads dance routine.

Daughter Jennifer and grandson Pax.

Gross Gang in Las Vegas, my old stomping ground. Left to right: daughter-in-law Jenny, son Jeff, daughter Jennifer, son-in-law Peter, Amy, and me.

Welcome to the William H. Gross Stamp Gallery at the Smithsonian National Postal Museum in Washington D.C. My mom's intentions of involving me in stamp collecting were eventually validated when I approached the hobby like a thinly held asset class.

Janus and Beyond

But now Janus was my new home. Why Janus? Or why not retire silently to a family office without the complexity of financial regulations and daily interaction with five or six new employees in Newport Beach? Good question. The answer is I should have, but didn't. I think I waited to show the "public", and of course PIMCO, that I still had the magic, but the magic seemed to have disappeared. While I was retained by George Soros and a few existing PIMCO clients to manage total return accounts, the bulk of the assets, including $500 million of my own money, were structured with an "unconstrained bogey", an account that allowed for much more risk-taking than total return accounts, which permitted only bonds. I suppose there was a good reason why I never became known as the "Unconstrained King". While I made money for clients over the next four years, the results were below par and below industry standards and medians. I missed the positive interaction of PIMCO's Investment Committee I suppose, and my fixation with the overvaluation of German Bunds proved my undoing. On February 4, 2019, I resigned without

any pressure from CEO Dick Weil. The “King” was finally dead, although there was life and joy to come in my personal life.

Three months after my second divorce in 2016, I met a much younger lady, Amy Schwartz, who was introduced to me by Bill Powers — a former PIMCO partner and managing director, who had managed the mortgage desk. Amy and I corresponded once or twice via text. She sent me a picture, said she was a former professional tennis player who had played at Wimbledon and the other majors, and I said, why not? I had been publicly divorced three months earlier and I wanted to pack as much life as I could in the active years I had left at 72. So I invited her to have a drink with me if she was ever in Newport Beach. She rather craftily texted back that if I was ever in Santa Monica (which was 30 miles to the north) that she would love to have a drink. I was up there two days later. She transitioned from professional tennis to amateur golf after we met, and was the first female winner of the AMEX “Bob Hope” Pro Am two years later, defeating nearly 300 competitors including myself. We’re on the course nearly every day now as I try to beat her. Sometimes I do. Usually not.

Four years later, we were married at a backyard ceremony at our home in Indian Wells, California. I am a happy man in retirement, still getting up at 6 in the morning, working five hours in front of a Bloomberg machine, with a workout and afternoon of golf to follow. My

kids Jeff and Jennifer, and their kids Caroline, Lila and Pax, are an important part of my life. Prior to my divorce I was intimidated from seeing them as much as I wanted. That has changed. We're a new family. Who could ask for more. I'm still involved in philanthropy, having signed the Bill Gates and Warren Buffett "Giving Pledge", after already distributing over a billion dollars to worthy causes and to extremely needy individuals and families via what I have called the "Tipton Fund" – a follow-on to a 1950s TV show called "The Millionaire" where the rich guy's butler (named John Beresford Tipton) knocked on needy families' doors and gave out a million dollar check. My checks are smaller than that, but helpful I'm sure. Signing the checks is very joyful as well to me. Last year my Tipton Fund gave out $14, 000 to each of 55 maintenance workers at my Vintage Club in Indian Wells, California. Wow — the difference that must have made in their lives.

Philanthropy is an interesting topic. Many rich philanthropists say that "giving away money is harder than making it, " but I'm not so sure. Those claims are based on the donor's need to control the pieces I think. Foresight and proper control is essential in most cases I guess, but there is so much need in the world that setting up new "boards" and quarterly meetings to monitor results seems like a "me" thing for alpha males (women?), and not a "them" thing. My advice to future philanthropists would be to find existing institutions like the Red Cross or Doctors Without Borders

(my favorite) and start writing checks. And forget about semi-permanent nameplates over hospitals and universities (I’m guilty of this in my early years). Start a Tipton Fund of your own like I did with my childhood friend Jerry Hearn, or donate to organizations that give money directly to needy people and families like the “New York Times Neediest Cases Fund, ” with advice from a philanthropic professional like Mark Porterfield for me. Mark to this day oversees my William, Jeff and Jennifer Gross Family Foundation, making sure we donate to areas where it’s most needed, and where our contributions can make a difference. Give $20 bills to homeless people on the street. Maybe some of it will be misspent but some won’t. That’s better than funding a now anachronous university building, that is being pushed aside by online education these days.

About Investing

So much for reminiscing and philosophizing. How about investing and the state of the global economy. Before I start let me inform you as to my personality biases. Jesse Livermore, the trading sage of nearly a century ago, alerted me to the importance of knowing yourself before pretending to know other investors. Investors by nature are risk takers, even those that stick to bonds or money market securities. Bonds, stocks, real estate, cryptos — they all involve converting cash to a more illiquid security and it’s this illiquidity and maturity extension, in addition to the chance of not getting your money back (even for Treasuries in inflation adjusted terms) that constitutes the risk I refer to.

I’ve always thought of myself as a “measured” risk taker — meaning “calculated”—using research and probability assessments to allocate investment portfolios just like with blackjack. Stretching that “calculation” over long periods of time with what I ingrained at PIMCO with its “secular” outlook, fit my “measured” description as well. Much of this approach came from my blackjack years and Thorp’s “Beat the Dealer” where he described a method of betting called

“gambler’s ruin” that limited individual bets to 2% of a players chips even when the odds favored the player.

I used this system at PIMCO and it produced consistent outperformance over time. I abandoned it at Janus in an attempt to outrace PIMCO in the few years I thought I had left in the public’s eye. Not too smart. My ego got the best of me there.

In any case, this approach fit the requirements of a fund manager — protecting principal above all with a secular outlook, then buying cheap bonds along the way. I always told clients that I was “a glass half empty” as opposed to “a glass half full” type of guy. Stock managers are the opposite. So now that you know about my Freudian personality analysis, let me proceed with several forecasts.

A Virus in Modern Day Capitalism

There is a virus in modern day capitalism that creates increasing risk for investors. This virus is not a new one like COVID 19 or COVID D, but a centuries old financial molecule called "debt". When governments, corporations, or individuals create too much of it, problems result and crises become more probable. To repeat that old financial chestnut, "He who sells what isn't his'n, must buy it back or go to pris'n." That was actually referring to short selling but same thing with debt creation. Bonds and paper guarantees are initially sold, but when not paid back or serviced by paying interest, bad things can upset the norm. History is rife with classic examples such as the "South Seas Bubble" or the "Tulip Craze" or even Ponzi schemes like our more recent Madoff scandal.

With too much debt, money and liabilities for future payment somehow sink down a rabbit hole and normal commerce is disrupted. That has always been the bane of capitalism as Hyman Minsky so eloquently described it 50 years ago. A mismatch between equity and liabilities –

either by maturity or volume — can create risk. We are experiencing that today on a global basis – mainly on government balance sheets but increasingly on the corporate and personal level as well where individual investors have created the cult of equity, cryptos, NFTs and now the metaverse instead of cash-flow sensitive assets that pay out dividends. The financial crisis of 2009 is our most recent example as individual subprime floating rate mortgages began to default and banks and investors that held those obligations saw a shocking loss of balance sheet equity. Government rescues in the form of 0% to negative short term interest rates as well as outright purchases of Treasury and corporate debt known as "quantitative easing" came into existence for the first time to salvage the system, but in effect just exchanged private liabilities for public liabilities. The debt in no way disappeared. It just popped up somewhere else.

Today Treasury obligations as a percentage of GDP have risen to 125% and similarly other developed and developing nations have shown the same increasing trend or worse. But the question is for me and for you as investors – how much debt is too much? I can write and quote frightening statistics, but as I write, economies and certainly equity markets seem to be doing just fine. 125% of GDP? Should investors care? They should, if those and increasing levels of debt begin to distort the "system". They should if annual

government deficits in the U.S. for instance remain at $1 trillion to $2 trillion for an indefinite future.

It's not that our Treasury (and other government Treasuries) can't continue to pay for those deficits. Modern finance has found a way to meld Treasury and Central Bank behavior to ensure that the debt will be issued and at low rates. It's just that the increasing debt may have the tendency to increase inflation, and that the low to negative yields (in nominal and importantly inflation adjusted real terms) begin to destroy the savings function so necessary for the success of our capitalistic system. If for instance, inflation as a result of trillions of dollars of annual deficit spending increases to 3% or 4% as opposed to 2% and the Fed continues to keep control of 5, 10, and 30 year maturity levels at 1.25%, 1.50% or 2%, then private investors logically and increasingly will desert bond markets for a chance of higher returns in stocks. But at some point, this risk to stocks or cryptos, or NFTs, may create a bubble and a potential crash (did I say that?). Tulips, subprime, it's happened before.

My point is that if economic growth becomes increasingly dependent on deficit and debt creation, an economy's balance sheet becomes distorted, as does the ratio of debt to equity on the right side of the balance sheet. The old 60/40 stock/bond standard becomes 70/30 on the asset side and even higher. The 70% in stocks of course is riskier and

accidents, or plagues, or global warming effects become potentially more destructive.

Is it possible that increasing debt levels may not result in higher inflation and a rush to bubbly investments? Yes. Demographic trends that inevitably point to an increasing age of citizens in almost all developed countries favor lower consumption and thus lower demand for second cars, second homes, and the “things” that Boomers once thought they needed. Japan, for example, is the demographic Petri dish of the word and for years has fought to fight deflation and to unsuccessfully increase inflation. The Japanese Treasury issues more and more debt, their Central Bank buys almost all of it at near 0% interest rates and the country seems to be doing ok.

An observer wouldn’t exactly say that their stock market is doing well but no bubble, and no popping so far. So higher debt levels on the balance sheet and in the hands of the BOJ appear innocuous – for the time being.

Why can’t the U.S. thrive in the same way with our own low yields and periodic quantitative easing? It’s possible, but despite the Japanese example, the history of credit booms for centuries show that they almost always end – and sometimes disastrously. The South Sears bubble in 1720 was one of the earliest examples, but the U.S. has experienced many during the past few centuries involving railroads, real estate, and excessive leverage elsewhere. The Great Depression, the Dot Com boom/bust and of

course the more recent Great Recession centered on subprime mortgage debt should be cautionary tales to today's investors. Our current boom, created by finance-based capitalism (credit creation) run amok, is viewed by many as a boom without consequences. Almost every dollar-based asset class has jumped into the excess liquidity pool, drenched by cheap and available credit that in turn has led to high P/Es for stocks and low cap rates for real estate. Crypto coins, SPACS, and NFTs are along for the ride as well – the metaverse is another recent sensation that creates legitimate questions in terms of present value.

But back to our modern finance-based economies. To describe our current-day financial markets in the above way is not to downplay progress in finance, but simply to wonder what happens if the primary stimulant – low interest rates – moves significantly higher. What could cause that in light of the 20-year Japanese experience? The answer is obviously persistently high and higher inflation and the withdrawal of Fed quantitative easing now underway. Current year-over-year (YOY) CPI increases are fluctuating around 5%, a level that if permanent would cause bonds and stock prices to plunge and present the possibility of another Great Recessionary crash. I think that the current 5% YOY rate is temporarily high, to use Jerome Powell's jargon, but think as well that the Fed's 2% target is illusionary. Deficit spending of $1-$1.5 trillion a year is baked in the cake with COVID legislation just a part of the reason. There are current

prospects for huge spending increases in future congressional spending bills, a la Biden's *New* New Deal. Government spending worldwide is moving higher as a percentage of GDP. Inflation will likely move higher than the Fed's target of 2% and in other developed and developing countries as well.

As a brief aside, you may have an interest in my views on crypto currencies, NFTs and AI. NFTs are obviously a difficult concept to understand and I believe there to be bubbles there. But I am cautioned to not completely rule out this new metaverse and its fellow facilitator, artificial intelligence. In a recently published book authored by Henry Kissinger, Eric Schmidt, and Daniel Huttenlocher titled "The Age of AI", they introduce the potential to take the metaverse seriously: "Whether we consider it (AI) a tool, a partner or a rival, it will alter our experience as reasoning beings and permanently change our relationship with reality."

While there are literally hundreds of them to choose from, the main two leaders – Bitcoin and Ethereum – seem to me to be survivors and probably even thrivers in future years. With the Fed and major central banks engaged in historically loose monetary policy that includes both negative interest rates and trillions of dollars of quantitative easing, there is an obvious interest and future demand for transactional currencies that have limits on their future supply. While both these major crypto currencies have price

volatility that limit their current acceptance in everyday transactions, there should come a time from unknown price plateaus when daily fluctuations are significantly less. If so, and if cryptos can avoid government confiscatory legislation like gold experienced in the 1930’s, then they have a decent chance to move alongside the dollar and other major currencies in importance. I myself own a small percentage of assets positioned in Bitcoin. I expect it in future years to appreciate more than the S&P 500.

But forgotten in all of this discussion on current deficits and increasing levels of debt are the demographic demons of Social Security, Medicare, Medicaid, and other age-related necessities that divert prior private and public productive investment into keeping Boomers (myself included) healthy. These programs resemble the broken window paradox. Breaking a window, then repairing it can be positive for GDP, but it doesn’t enhance productivity which is the critical ingredient in “real” non-inflationary growth. Thus, aging and health-related spending percentage increases may fix broken bodies, but the deficits that result are primarily inflationary because they primarily maintain the status quo by keeping people alive.

The impact of age-related healthcare and other policy “guaranteed” spending programs can be understood by estimates of the “present value” of all of these required future spending programs. The U.S. government’s own agencies calculate that the discounted present value of

these future programs are at least $40-50 trillion dollars, a figure that if accurately included in debt/GDP calculations would almost triple our current ratio from 100% to 250% or more – putting us in the category of many emerging market countries with lower-than-investment-grade debt ratings. “Demography is destiny” rings the old saw. Even assuming the minimizing of COVID and related viruses, the U.S. Treasury will be issuing trillions of dollars a year in new debt without – perhaps – a willing Fed to buy it with both hands. Be careful about the U.S. mimicking the Japanese 20-year experience with low inflation. Unless our central bank buys most Treasury issuance like the BOJ has done, interest rates on the 10 year treasury will certainly rise from 1.50% today to 2%, 3%, and maybe 4% over the next decade. If so, our currently successful finance-based economy is at risk and stock prices may suffer compared to recent history.

OK, so just to empty a little more water from this half-empty forecasting glass, let me just give you my take on today’s markets absent the future influence of these negative economic forecasts and statistics. Let’s talk about the current investor confidence in the future. I have to laugh at the opening bell ceremonial telecast on CNBC every morning at 9:30 EST. Here are a bunch of millennial and Gen X “investors” clapping furiously as if their IPO’s and their belief in inevitably climbing markets are “guaranteed”. Admittedly, I rang the bell once for a PIMCO ETF but a smile and a few handshakes were all I gave and got in return. But

today’s investors are “excited” people – the current adjective for every CEO and commentator extant. They are always excited and “absolutely” sure in every response. Investors with both bull and bear market experience should know that their “hurrahs” are something to fear, not cheer. Too enthusiastic! The new stock queen, Cathie Wood, seems a two-year wonder to me. She’s smart but trades huge blocks of stock daily that cost her investors lots of money.

I sometimes even get carried away myself, going from conservative to speculative investments after listening to Jim Cramer and others who seem to presume that stock markets these days go up 80-90% of the time. I like Jim; he is the financial showman of our era, certainly more entertaining than Louis Rukeyser of “Wall Street Week” fame when I was a guest and a panelist. But you should not get “excited” about commentators’ double-digit forecasts for broad indices or high-flying stocks, even with the advent of electric cars, batteries or the metaverse. As you may know, I’ve forecasted miserably before, as evidenced by my “Dow 5, 000” prediction in a 2002 Investment Outlook included in the appendix for humility’s sake. But current high prices and future age-related demographics argue for caution. Stocks and even bonds can thrive with low-to-mild future inflation. But anything beyond 3% and higher are market threatening. Don’t get too “excited”.

There are other reasons to be cautious. Historic wealth gaps between the 1% and 99% of the rest of the country;

the lack of private pensions beyond Social Security for a majority of American households (their average long-term savings is less than $90, 000 – hardly enough to last 20 years or more); geopolitical risks with Iran and China; cyber security threats from known and unknown sources; civil unrest here in the US; and of course the biggest enchilada of them all – <u>global warming</u>. All of these pose threats to corporate profits, inflation and central bank miscalculations that continue the current monetary easing course meant for COVID recovery alone. There may soon come a time when the warnings of that old newspaper sage of the 1930's – Will Rogers – comes back again. He wrote at the beginning of the Great Depression that, "I'm more concerned about the return <u>*of*</u> my money than the return <u>*on*</u> my money." To be sure – don't be losing yours. Invest cautiously without high expectations.

Epilogue

A few years ago, a Wall St. Journal reporter called and asked me for an interview. “What’s your objective???” I inquired and when he said he wanted to confirm some facts for a pre-packaged epitaph I had to laugh and continued laughing even after hanging up. I was still standing and not near the grave, I thought, and might even outlive his career at the Journal. Besides, who would really care? Almost all epitaphs are relatively meaningless. Life quickly moves forward even after the most public of personages pass on. I suppose this book is my epitaph and for those of you who have gotten to this point, I expect you to move on rather promptly as well. But thanks for reading.

Still, in signing off with this epilogue, I have a few remaining admissions and/or philosophical comments.

I’m reminded of Frank Sinatra’s song “My Way” in which he admits that “regrets – I’ve had a few, but then again too few to mention…” My PIMCO regrets have more to do with nudging (not shoving) Jim Muzzy and Bill Thompson out the door. They deserved to make their own decisions. Other than that, well, I was a pretty good steward of PIMCO and its

historical role in the financial markets. Was I often secluded and demanding? Sometimes. But PIMCO was a business family to me and my personality as with any family was formative, and in this case productive.

Like my Mission Viejo neighbor urged for me 40 years ago, I wanted to get laid career-wise, and I learned to publicly say hello. But exposing oneself to even a small audience entailed risks as well as rewards. I knew it then, and I certainly know it now. But no regrets. Most of my regrets are personal and they will stay that way. A billion Chinese could care less and that includes you. Still, I will admit that even with personal regrets, I've led a wonderful and privileged life. A white male, growing up post WWII, in the Midwestern U.S. of A with parents who cared about my future; surviving Vietnam; finding the perfect job at the perfect time; being healthy; having family problems but emerging with a son, a daughter, three grandkids and a new, younger, energetic wife – all of whom love me. Son Jeff at 49 is a professional sports photographer, having won two photographer of the year awards from Getty Images over the past decade. Daughter Jenn at 45 graduated summa cum laude from Duke and has been instrumental in the Vatican's world hunger efforts over the years, traveling many times to Africa in her efforts. Both of them are directors and eventual successors for our family foundation totaling $500 million in assets. And both have great families.

Amy – my wife for life – fills my days with joy and the anticipation of new experiences.

My gait is a little shorter now – my posture increasingly stooped. But hey! 77 and still working the markets from 6:30 am until 1 pm, with time for a workout and then golf thereafter. I just shot an 82! Who could ask for anything more!! Thank you – fate – good fortune –karma – and yes, a lot of hard work from me and many others along the way as well as support from family and friends. I'm trying to pay it back with my Tipton programs and larger philanthropic projects, as does PIMCO with its own foundation that I founded (and funded). I hope I have time. Unlike Vietnam my ship sails more slowly, now toward an uncertain shore, as I wait for the land to come home to me.

Still I wonder about this thing called "life". Don't you? My questions are encapsulated in a book and ultimate movie called "The Hours" describing the life of author Virginia Woolf. "Where do we go when we die?" asks Woolf. "We go back to where we came from" replies another. "And where was that?" "I don't know" comes the final response. "I can't remember".

And so my career hours have passed, forgetting much, but with hopefully still some more personal hours to remember. I don't know where I came from or where I'll go when I die. But I do know that I'm still standing.

END

APPENDIX

When I last introduced a “select collection” of Investment Outlooks in a bound volume in 2003, it was a different time. Notwithstanding the then-freshly remembered horrors of 9/11, I wrote about “how upbeat and problem-free most of them were from a personal standpoint.” I said then: “It’s been a wonderful time to have lived and loved and worked – free from the pain that much of the world has and is continuing to experience,” and I still believe that, despite a few nicks and knocks since. I’m happily remarried, blessed with new grandchildren, and enjoying a retirement that leaves more time for philanthropy and the occasional, though elusive, near-perfect game of golf. In other words, I’m still standing.

I hope you enjoy reading this latest select collection as much as I enjoyed writing them.

BG

Selling the Noise

Investment Outlook - April 1988

President and Mrs. Coolidge, visiting a government farm, were taken around on separate tours. At the chicken pens Mrs. Coolidge paused to inquire of the overseer whether the rooster copulated more than once a day. “Dozens of times, ” said the man. “Tell that to the President, ” requested Mrs. Coolidge. The President came past the pens and was told about the rooster and Mrs. Coolidge’s question. “Same hen every time?” he asked. “Oh no, a different one each time.” Coolidge nodded. “Tell that to Mrs. Coolidge, ” he said.

Well, “Silent Cal”, our 30th president, may not have had much to say, but he was certainly successful in pointing out that there are two different ways to looking at a chicken coop or a rooster, as the case may be. This story, which actually led to the formulation of a scientific principle on human sexual behavior called the “Coolidge Effect” (contact your PIMCO account manager for a more thorough explanation) reminded me of some recent differences of opinion on, of all things, bond and stock market volatility. (Right now I feel like the investment manager counterpart of a used car salesman practicing bait and switch. I’ve grabbed you with the sexy intro, now I’m about to shift gears to the more expensive model.) At Pacific Investment, as most of

our readers know, we place a high degree of emphasis on volatility analysis because buying or selling volatility at the right price can make a lot of money. With embedded options attached to almost every bond in the marketplace, the proper stand on market volatility is critical. Corporate bonds with call options, for instance, or mortgage pass-through pools with prepayment provisions, or even noncallable Government bonds with “convexity” characteristics, all have options which vary in price when the financial markets become more or less volatile. Because this is so, yield spreads between corporate, mortgage and Government issues move back and forth like an arrhythmic pendulum. Although some of the movement is due to economic expectations and pure supply and demand considerations, the optionable characteristics of bonds rank near the top of any active money manager’s “most significant” list.

What prompted the topic for this Investment Outlook, however, is not a recognition of the obvious, but a discussion of the not-so-obvious. Another point of view, as President Coolidge might have pithily proclaimed. For it seems to me that the preponderance of bond managers, while correct in their incorporation of volatility measurements for valuing bonds, almost uniformly make the mistake of overestimating the numerical calculation of what that volatility is. In doing so they invariably overemphasize the value of Government bonds versus non-

government issues in their portfolios and purchase overvalued issues on the yield curve.

This is a technical topic, and I can't expect to cover too much ground in one abbreviated discussion, so let me stick to the claim of volatility overestimation and see where it leads us. Investment managers can use any number of past time periods with which to "measure" volatility, but the most common range between 10 and 90 days. Options and bonds with optionable characteristics then, carry a value which projects into the future the same volatility that has recently been experienced. To put it in terms of a simple example, if the Dow Jones Industrial Average had dropped 200 points over the past month, stock options would likely be priced on the expectation that the Dow Jones would vary 200 points (up or down) over a similar time period in the future. Why is this wrong? Well, investment managers and many academicians operate under the false assumption that volatility is random, when in fact, price movements have fundamental economic and political bounds. If interest rates on long term Treasury bonds were to skyrocket from 9 to 10% over the next three months, classic option theory would suggest that long bonds would likely exhibit the same price volatility in the ensuing period (up or down) and should move within a range of 10 to 11% or 10 to 9%. The fatal rub for the random walk option prices, however, is that the 10% yield in and of itself is enough to slow economic growth and force interest rates back down. The 11%

scenario then, while equally probable as 9% under strict option theory, becomes fundamentally and indeed politically less likely than its downside counterpart. Option volatility, therefore, becomes overpriced because its extreme upside and downside “legs” or “trees” are not random and are therefore likely to be truncated.

An even more compelling argument comes from the co-originator of the option pricing model itself – Fisher Black. (The other founder, Myron Scholes, in an esteemed member of PIMCO’s board). Black has in the last several years coined a phrase called “noise” which he applies to the financial markets and to financial market volatility. Noise, Black says, is to be contrasted with information. Those that buy stocks or bonds on information are akin to, let’s say, Warren Buffet. Those that buy stocks or bonds on noise are typified by traders in the futures pits. Traders’ perceptions are injected into the markets in the form of intensified trading and wider price movements than would normally occur without them. Thus, the term “noise.” Now Black contends that noise destroys market efficiency. It makes it possible, in other words, for astute portfolio managers to add value to their clients’ portfolios. In a 1986 Journal of Finance article he limits his discussion of noise to the mispricing of low versus high priced stocks, but he opens the door to the mispricing of options as well. “Because of market noise….. the short term volatility of price will be greater than the short term volatility of value, “ he writes. If so, then money managers

which use short-term volatility estimates for longer-term option valuation are systematically overvaluing option prices. This distinction between short and longer-term valuation is critical, because most of the optionable characteristics of bonds (corporate calls, mortgage prepayments, and selected futures contracts) are longer term in nature but appear to be priced on 10-90 day volatility histories.

How can PIMCO take advantage of this mispricing? In our internal portfolio discussions we often talk about buying or selling volatility, and that remains a valid consideration. Value, as Black would call it, can be bought or sold depending upon its price. According to the above discussion, however, it seems a legitimate objective to gear our strategies toward “selling the noise.” Noise, over the long term, is relatively worthless and selling it makes all the sense in the world. Volatility can be bought if the conditions are right but noise should always be sold. To me, everything else being equal, that implies a bias towards financial futures, mortgage pass throughs, and in some instances corporate bonds, although the latter have so many options that it’s difficult to discern what is value and what is noise. Each of these sectors contains options which the buyer (PIMCO) is effectively selling to the issuer and to the extent they contain noise, our clients will benefit. In a sense, this strategy is the reverse of the portfolio insurers that gained notoriety during the October crash. Portfolio insurers buy

the noise. We have for a number of years been selling it an perhaps the credibility of each strategy has been demonstrated by their headlines and our bottom line.

Well, by now, most of you are probably sick and tired of “noise” and would prefer some peace and quiet. If that’s the case, I’ll refer you back to “Silent Cal” Coolidge. He made less noise than any president in recent history. As he once remarked, “I think the American people want a solemn ass as a president. And I think I’ll go along with them.”

William H. Gross
Managing Director

Echoes From Africa

Investment Outlook - April 1991

Echoes From Africa

If I sang a song about Africa
of the spotted giraffe, the hyena's laugh
of the fiery sun rising to meet the day
with a stillness belying the lion's evening meal
would Africa sing a song about me?

If I remembered a time once in Africa,
bride at my shoulder, chasing a leopard's shadow
with human eyes and Nikon shutters wide apart
Invading the solitude of blackened ancestors,
would Africa remember a time once with me?

If I knew a story of Africa
capturing a disappearing continent for a moment in time
Fleeting—far briefer than the earth's reign;
At least until its dusty death,
would Africa know a story of me?

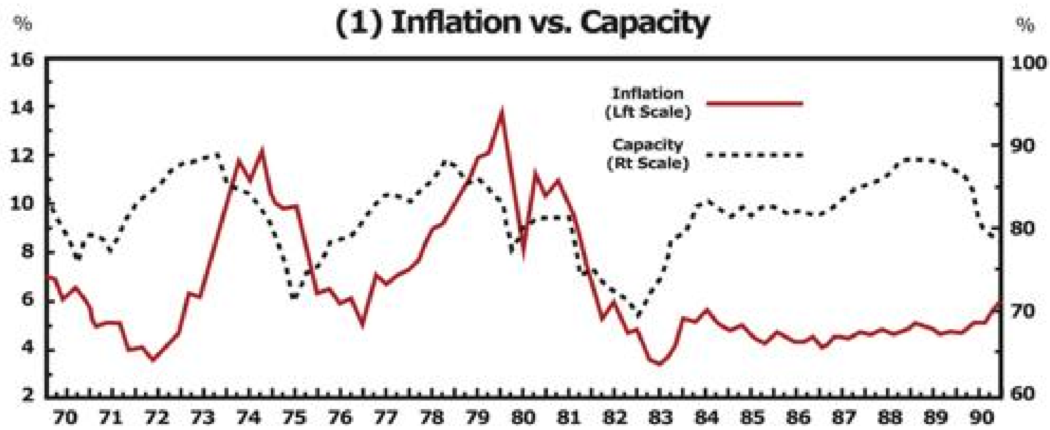
With appreciation for Isak Dinesen

I traveled once to Africa, as you might have guessed by now, and it's been a part of me ever since. Being perhaps the cradle of civilization, if not life itself, Africa casts an eerie glow over the entire history and, indeed, meaning of existence. There's a strange beauty to it—this eat and be eaten land—brutal, yet fair and loving underneath its violent surface. I think it's how I view my own life. I saw myself in Africa and, of course, through my own eyes I saw you there, too. The question, however, that ends every stanza of my poem is whether Africa saw and will remember me. Are we just passing through without a trace following our dusty deaths? Will anyone, or anything at the end of the line be the better for our time on earth? I, myself, know nothing of a grand scheme of existence, but I wish there to be one—if only to give meaning to our precious moments of happiness and frequent hours of despair.

Most Africans know little of the economic problems of Western society— recession, unemployment, inflation. It's no wonder that they have little experience with inflation. I bought a Ugandan money necklace several years ago that had to have weighed at least five pounds. You can't wear too many of those around before the joys of shopping start to wear you out, so I suspect consumer demand and, therefore, prices are well in check in the villages of Uganda. Here in the U.S., our credit cards are much easier to lug around, but with high levels of debt permeating American society they're starting to weigh almost as much as that

necklace on my library shelf. With consumers bogged down, and businesses at a relative standstill awaiting their rejuvenation, it's little wonder that our own inflation rate is starting to slow significantly. March's consumer price index of -0.1% was the first decline in over six years and the core rate (ex food and energy) of 0.1% was far below most expectations. While numbers of that magnitude will not be the norm over the balance of 1991, there is a good chance that average annual increases of 3% or so will characterize much of the period.

Understanding inflation can oftentimes seem totally confusing. Concepts such as money supply, cost push, oligopolistic pricing policies, and currency movements seem hard to relate to everyday prices. One of the problems is that even if well understood, they work with varying leads and lags that place the investor in a quandary as to when to move and what to believe. Over the years, however, perhaps the simplest concept to apply to future price expectations is that of aggregate demand. How robust, or how weak, is the economy and for how long has it been that way? The stronger and longer an economic recovery, the higher the probability that inflation will rise. The weaker and lengthier any given recession, the better the chances or a significant slowdown in future price increases. Take a look at the two charts below to get a feel for this apparently simple economic concept.



The first chart above displays a twenty year history of inflation versus capacity utilization, while the second chart compares inflation to unemployment. Notice that as more and more of our productive capacity in terms of plant (first graph) and people (second graph) are utilized, the greater the strain on inflation. On the other hand, during economic

slowdowns or outright recessions, inflation invariable falls. That this is so is not hard to explain. As more and more people are laid off, for instance, the ability of both existing and prospective wage earners to demand raises or higher paying jobs is hampered. When the supply of new workers is at a minimum, however, and unemployment is low, the pricing power of labor is at its peak and their higher costs often force prices upward. Similarly, with plant and equipment operating near peak capacity, new orders are accepted only at high prices. To fill them often means starting another shift at overtime wages, or bringing marginally productive machines back on stream. During downturns, though, pricing policy is much weaker. Companies are glad to get whatever orders they can and must keep prices down relative to both domestic and foreign competitors in order to do so. Not only do the graphs point out these relationships, but their lead times appear to be fairly consistent within a broad range. On average, it appears that it takes 1 to 1 1/2 years for trend reversals in capacity and unemployment to engineer similar changes in inflation.

Which brings us to the current cycle and the reason for optimism on future inflation. Capacity utilization peaked in late 1989 at 85% and has since fallen to 77% with lower numbers likely down the road. While the fall of 8% in terms of magnitude is so far a small drop in historical terms, the October 1990 peak inflation rate of 6.4% (12 month

average) is a much lower inflection point than that witnessed in 1974 and 1980. Similarly, while unemployment has been on the rise for only twelve months now, and is up to 5.2% to just 6.8%, it should continue to increase even during the beginning of our next economic recovery, sounding an all clear for inflation for at least the next 12 to 18 months before the cycle reverses itself once more.

Other, more complicated forces of inflation point in similar directions. Both domestic and worldwide monetary growth have been in downward trends for at least the past several years. Real monetary growth rates in the United States, for instance, have been negative since 1989 and with a diminishing supply of money in the system, coupled with an unwillingness of financial intermediaries to lend it at the margin, lower inflation cannot be far behind. In addition, commodity prices continue to behave themselves, if not decline on an outright basis. With wages backing down to a 3 1/2% annual rate of increase, and the cost of raw materials showing such paltry strength, prices of end products have to move in a similar direction. And lo and behold the U.S. dollar! Up nearly 10% from its floor just months ago, its revival can only accelerate inflation's decline over the next twelve months.

So fear not, Mr. Greenspan. You are fighting the war of the 70's not the 90's. While too much of a good thing (lower interest rates, rapid money supply growth) may eventually justify fears of a renewed inflationary spiral, that time is not

yet at hand. We have at least an 18 month window of lower inflation in store with 3% rates of increase to look forward to. Those numbers should be a blessing to bond investors with 8 1/4% long Treasury bonds and 8-9% intermediate corporate issues. They should provide the impetus towards still lower rates as we move into 1990’s second half. If PIMCO weren’t such an active manager, I might suggest we all just pack our bags and give this bull bond market some more time to cook. Summer’s almost at hand and the call of the road might be just the trick to get in touch with our roots once again. If you’ve got the inclination, you might try Africa. I remember a time in Africa … in Africa … in Af …

William H. Gross
Managing Director

Billy’s Last Mile

Investment Outlook - November 1991

I've been reading Michael Lewis' new book, The Money Culture, and in it is a story called "Frankie's Longest Mile" that I'd swear was adapted from my own compendium of tales, except for the fact that I've never met Michael Lewis, nor have I ever put the saga or "Billy's Last Mile" to print before this very day. It's a small world I guess, or maybe there's a lot more Frankies and Billies in this world than I've known until now. In any case, the essence of both yarns is that Frankie and Billy were—er, uh—runners. That's it. Out of shape runners to be more accurate. The fact is, they weren't runners at all, but "investments types" who thought they could return to the days of yesteryear, a cloud of dust, and a six minute mile. My story actually revolves around two Billies—myself and a wonderful man who used to share an office with me in the early 70's and is now the Vice Chairman of our parent Pacific Mutual and the Chairman of our own Board at Pacific Investment—Bill Cvengros. His name alone was enough to cause consternation among our secretaries back in those days. Not only could you not pronounce the "Cven"—it being Czech and far beyond the pale of the typical American palate—but the confluence of his name and mine, once Czechoslovakia was eliminated from the lingual geography, was enough to confuse even

the two of us. That, however, is a story for another day. This tale evolves around our mutual, yet distinct, attempts to run a six minute mile when challenged by our fellow workers. Thos that were there that day in early 1975 would surely recall that while no one felt either one of us had a chance, if any one was going to do it was going to be me. I, after all, had run the 660 in high school and had taken a turn or two on the indoor boards at Duke during my freshman year in college. Cvengros, on the other hand, was what you might call “athletic, but slow”. He could shoot the lights out on a basketball court, and was a scratch golfer, but he sort of plodded when he walked and his wife, Joan, to this very day claims that he even talks slow. Well, we were both given a few weeks to train and the kitty eventually grew to an enormous $50. It wasn’t winner take all, but if by some miracle we both broke the mythical six minute barrier for aged and out of shape athletes, then we had to share the bounty. There was, therefore, a sort of mutual inclination to wish each other ill. $25 bucks was, after all, $25 bucks.

We decided to race separately to add to the drama of the affair and, as luck or fate would have it, my turn came first. There was, as my memory will recall, a small crowd there that day. It wouldn’t have filled Yankee Stadium, but there was talk of hot dogs and pizza, and even a thought of anointing several of our secretaries as cheerleaders. That idea, however, was quickly squelched by the “Doubting Thomases” who were fronting the $50 bucks. Their incentive

was to keep the adrenalin level low and to escape with their egos intact and ours somewhere near the cinder level of the track. Bang! went the mythical gun and I was off – without a cheer, but lots of hope, if only from within. Maybe it was the basketball shoes, or the memory of how I would get sick both before and after every high school race, or the recollection of my mother admonishing me that if God had meant people to run on a track, then surely he wouldn't make them vomit on the infield. I don't know, but the fact is I didn't make it. Six minutes and seventeen seconds was the call, and I was quickly flat out in the infield and rehashing familiar territory. After a brief period of mourning that spoke more to fear than to respect, Cvengros toed the line and was soon in pursuit of what he now knew was a $50 pot. To this day, I swear it must have been the knowledge that the $50 could be his, and his alone. Either that, or his heart.

It certainly wasn't his feet. But with half a lap and 220 yards to go, Billy the Flash had more than a chance. He had, in fact, one full minute to finish. After having taken five minutes to finish 3½ laps, he now had the luxury of sixty seconds for the last half. Not being a runner, though, Cvengros had made the almost always fatal mistake of going out too fast and it was now that his legs, or what was left of them (amorphous sticks of gelatinous rubber would be a better description) cried out for oxygen. There was little, if any, perceptible movement on the track. My mother, with her infinite wisdom of racing, could have walked faster.

But the ladies, sans pom-poms, were screaming for the Flash and I must admit, so was I. If I couldn't get the $50, then maybe at least he'd buy me lunch with his. 5:50, 5:51, 5:52, time sped up. Cvengros stood still. But somehow he and that finish line met at an instant just barely short of 6:00 minutes. It was over, he had won! He didn't seem to care as he staggered to the infield and make a deposit with no return just yards short of my own.

As it turns out, that was Billy's first and last race. I went on to run an assortment of 10K's and miles under six minutes, if only to prove that I, too, could do it. But the race and, of course, the story belongs to Bill Cvengros. It was not that day though, but the following years, that proved what a strong heart combined with Cvengros's staunch midwestern morals could do – with a family, a career, and a life. We see each other less frequently now, but I still consider him my friend, and my respect is enormous. It was Billy's last race, but just the beginning of a more lasting and meaningful quest. He never did buy me lunch though, and for that I think I'll never forgive him.

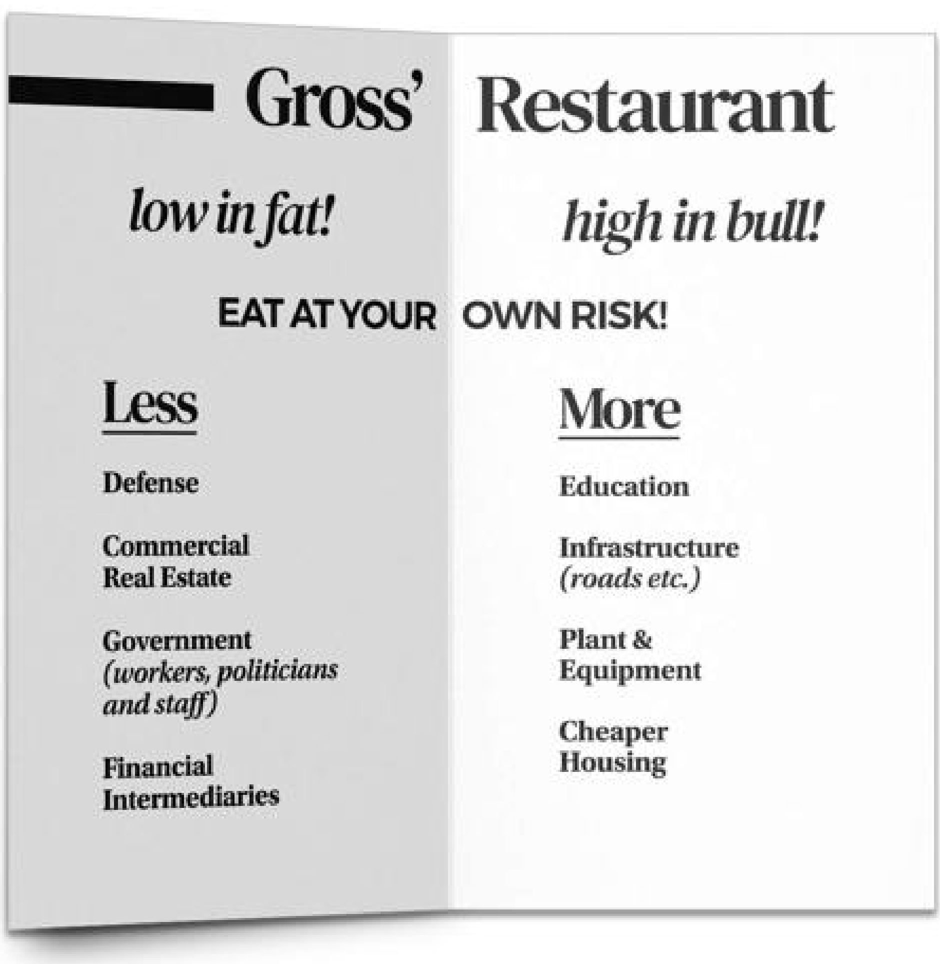
When speaking of wobbly legs and exhausted racers, the first reference in investment terms naturally flows towards the U.S. economy and the recent downdraft in the stock market. Call it fortuitous, or just lucky – I don't care – but my "Outlook" last month on the overvaluation of stocks due to poor economic prospects in the 1990's may have been more on the mark than theories blaming credit card caps or high

capital gains taxes. It seems to me that the "market" realized in the first few weeks of November that there were limits to how far the Federal Reserve could go in lowering short term interest rates. Further declines would only exacerbate a weak dollar, leading to higher inflation down the road and a flight of capital to foreign markets offering short term yields nearly twice as high as in the U.S. That in and of itself was not enough to send stock investors racing towards the exits. When they realized, however, that the twenty-four cuts in the Fed funds rate since 1989, and the three discount rate cuts over the same period had done little, if nothing, to rejuvenate the economy, it was every investor for himself. Sell first – look for signs of recovery later.

This economic anemia should come as no shock to PIMCO clients. Our Secular Outlook has for several years now build a foundation for stagnation or worse based on the debt balloon, the precarious condition of our financial intermediaries, and the high real interest rates that have been extended into the 90's by Japan's property bubble and Eastern Europe's property bubble. Let us know if you'd like some past copies of "Outlooks" addressing these topics. What I'd like to speak to this month, however, is the subject that the stock market seems to have just awoken to – and that is the duration of the solution. It will take us years to work out of this economic mess. To show you why, let's look at an economic menu of sorts. Pretend you're going into

your favorite restaurant, only in this case you can’t order swordfish or spaghetti and meatballs, but you’re force to list on the right hand side items which our economy needs more of, and on the left, things we need less of. Are you ready to order? (No cocktails – you need to be clear headed for this meal.)

Here’s my menu:



Now I know your menu would probably look a little different, but I'll bet at least a few of the items on mine would make it to yours as well. You may, for instance, have been inclined like Harris Wofford, to put medical care on the "More" side. I kept it off, seeing as we already spend the highest percentage of GNP in the world on medical care. But let's not quibble. "Good eating!, " you say. But, so what? Our economy has always needed more of some things and less of others. True enough. In the late 70's and early 80's we decided we needed more defense and office buildings. Could we have had a stronger economy? Not likely. In the late 40's we made a startling transition from guns to butter. Economists said it would never work and were prepared for a renewed depression, but it didn't happen that way at all. Why not?

It didn't happen in both of these instances because there was sufficient liquidity in the financial system to allow the transition to occur smoothly and with dispatch. The forced savings of GI's and American workers in the decade of the 40's was just itching to find a home after V-J Day in 1945. Because business could borrow cheaply, and were in many cases confident of selling their product to hungry consumers, tank factories were quickly converted to making Fords, and parachutes became nylons almost overnight. In the 80's Reagan had not such pool of savings to draw upon so he make up his own source of financing by ballooning the Federal deficit from $30 to $200 billion annually. If American

consumers didn’t have any money left , he’d borrow it – from overseas if need be – and his supply side transition became a fabulous success. We had guns, we had butter, we had an office building for every S&L executive who wanted one.

The problem was – the problem is – there’s no money left. With the American savings rate at an abysmal 3-4%, far below almost every other world economy you can name, and with the rest of the world looking inward towards their own needs, capital has become not only expensive, but to tell you the truth – scarce. There will be no sudden gushers of liquidity a la the 40’s or the 80’s to finance our needs in the 90’s. Education? Great idea, but you can’t raise taxes today or fund it at the state or local level. Cities are going bankrupt, states are running deficits. New roads? Sure. But for every new road you’re going to have to build one less plane, and the job lost will cancel the job gained. The fact is, that economic growth depends on land, labor, and capital – and it’s the capital that we’re desperately short of. In the simplest terms, it’s a situation like the one our ancestors faced on their start up farms on the prairie. In the middle of winter with mouths to feed, Mom and Dad could either eat all their corn, or save some of it to plant for next year’s crop. Those that saved the most found that their harvest grew the next year. Those that saved the least were reduced to near starvation and borrowing from their neighbors for winters on end.

There is no doubt that this transition form one side of the economic menu to the other can take place under almost any economic environment. Humanity eventually gets what it wants, or at lead needs. But the shift occurs much more quickly when there is an available source of savings and liquidity. In the late 40’s, it was our own funds, stored up like the seed corn of the prairie through years of sacrifice and doing without. In the 80’s, the funds were imported from Japanese and German lenders who emphasized thrift at the expense of consumption. Today there is no pool of domestic savings to draw from, no “small” Federal deficit to inflate, no unaccountable Fed to print limitless paper in a noninflationary world, no foreign moneybags that favor the U.S. versus their own domestic needs. We can only trade tit for tat, this for that, and the exchange will seem excruciatingly slow because of our historically low savings rate. Come to think of it, the 90’s economy sort of reminds me of Bill Cvengros. To paraphrase his wife, by the time this is over, it’ll even talk slow. But Bill won his race, and if we as a nation are to win ours, it will take savings and sacrifice and maybe just half the heart that Billy the Flash showed that day when he beat the six minute mile.

William H. Gross
Managing Director

Back to Butler Creek

Investment Outlook - July 1993

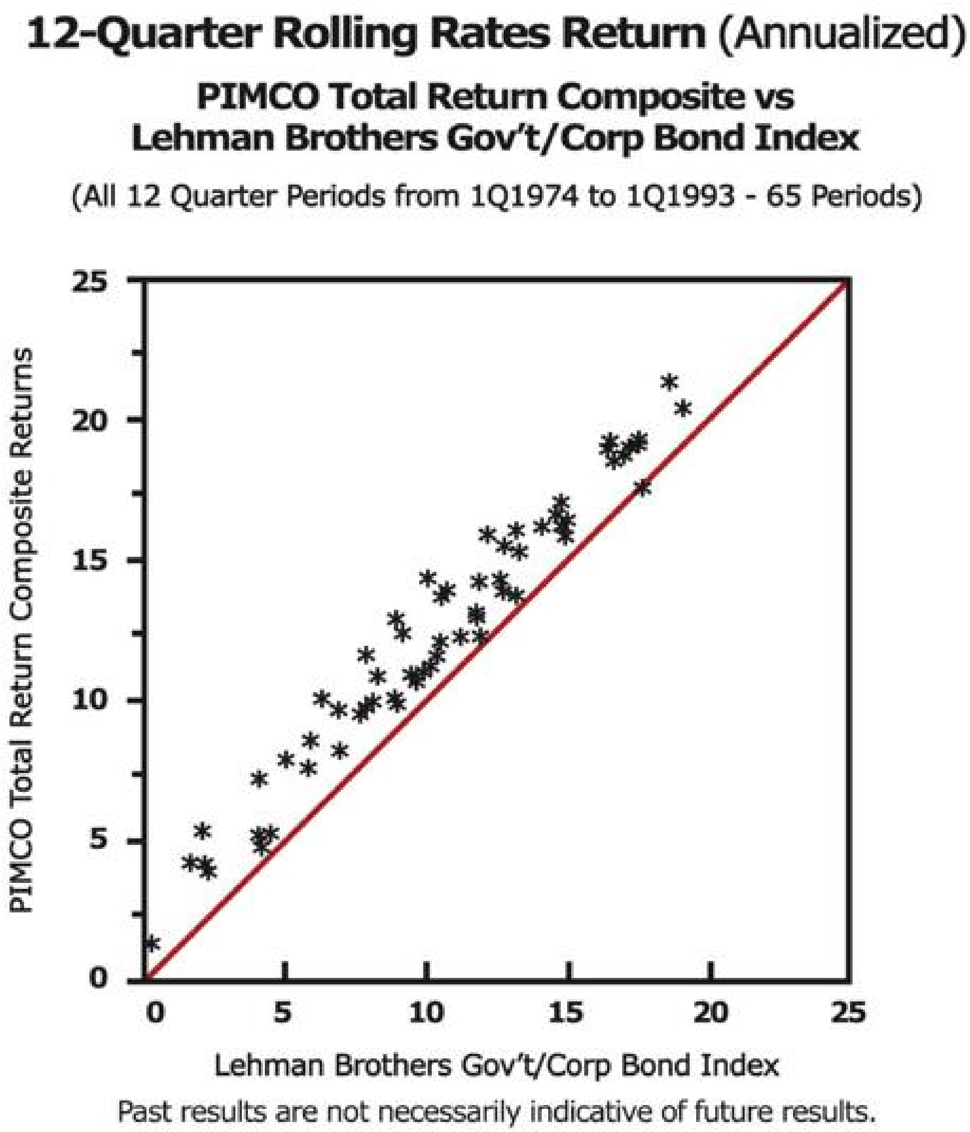
I never lived near a river. The closest I ever got I suppose was Butler Creek in the backwoods of Middletown, Ohio when I was a boy. But it was gentle and kind and its surprises came in the form of crawdads and salamanders and all sorts of fun things that little boys dream pleasant dreams of. There were no nightmares in Butler Creek. No levees, no sandbags, no shattered lives, no Presidents to commiserate. It was not, the Mississippi. My summers were days filled with running to not from the water. There were fish to catch in that deep eddy underneath the exposed roots of what had to be the county's biggest and oldest oak tree. There were BB guns to shoot at my brother and any make believe bad guys lurking in the underbrush. Lots of turtles to find. An abandoned shack that quickly became a fort. Buckeyes to pick. I never lived near a river.

Now I live at the ocean. Friends joke that the next tsunami will sweep that house away like the Mississippi rolling through Des Moines, but I know better. It's 50 yards from the beach and as untouchable as the homes of all my neighbors sequestered behind the gates of Irvine Cove. My children surf, make sand castles, look for crabs, and do all the fun things that kids dream pleasant dreams of. There are tress to climb, parks to play in, bikes to ride and nice

cars to drive. They've never lived near a river. Will they ever? I don't know. As a parent with 49 years of life experience it seems like the ideal wold be for them to experience a few floods before they're 35 or 40 so that they'll know how nice a creek is during the second half of their life. That's hard though. First of all, you don't intentionally throw your kids into a raging torrent. Kicking them out of the house at 21 is one thing, but when they're hurting and you can help, it's oh so hard to say no, even when you realize that in the long run, a "no" is the better response. Secondly, even if you try, life or lives can't be engineered so smoothly. It's full of hard knocks and heartaches even for kids who live in Irvine Cove and no matter how many sandbags you have, you just can't build the levee high enough.

Bond managers have lived in their own privileged world for the past 12 years or so when all you really had to do was own the "market" in order to look good. And outperforming your competition throughout the entire period might simply have been as easy as extending duration by one or two years, packing the suitcase, and enjoying an extended vacation on the French Riviera. I'm here to admit that life (and managing bonds) is just not that easy. When the flood comes or the tide changes, you'd better be prepared. It's important to be a manager for all seasons. Now before you start anticipating what I'm about to say, allow me the privilege of interjecting this one brief commercial for a bond

management firm that has been just that over the past twenty year. The graph below shows a succession of PIMCO's 12 quarter or 3 year rolling rates of return when compared with the Lehman Brothers G/C index since 1974 when we started to manage money.



Notice that each of the stars or asterisks are above the 45-degree line, a line that signifies “at the index” performance. Not once have we underperformed the market for nearly 20 years, and that’s a claim that very few, if any, investment firms can make. Bull markets, bear markets, it never mattered. We whipped ‘em both, anytime, anywhere, and through the years our goal of providing clients with at least over 100 basis points of performance over and above the market has been the result.

Let me return, though, to my comment about all seasons and suggest that what lies ahead may be a period that is neither fish nor fowl, is neither bull nor bear, but is a market where interest rates and the economy meander through time much like the Butler Creek of my childhood – calm, placid, little turmoil, low volatility. I suggest that no bond manager alive and active in the business today has experienced conditions which we are about to see: A market where duration extension or duration reduction becomes secondary instead of paramount; a market where the rewards from shifting from a barbell to a bullet and back to a barbell yield curve structure are mitigated by relatively mild changes in yield curve shape; a market where the benefits of buying washed out industries exemplified by auto and bank bonds are minimized by the diminution of major secular changes in credit quality. We are, in my measured opinion, headed towards a Caspar Milquetoast market. We’ve shot the rapids, gone over the waterfall of

plunging interest rates, and are now about to navigate a far more calm and placid stream than we’ve ever managed before. We are in a new season. Not only that, but we’re floating down an interest rate river that crested at 15% in 1981 and now measures in the 5’s and 6’s. Somebody bring out the poles, this barge will need some help to reach its destination.

What, then, to do. Well the answers, while not simple, become obvious after a lot of conceptual thinking. In a non-volatile world, you want to sell not buy volatility. In a world where price movement is relatively small, you want to emphasize yield and not simple duration. In a world where corporate quality spreads widen and narrow more slowly, you want to look for other “sectors” to rotate into and out of that exhibit more rapid changes (international bonds for example). In a world where remaining liquid in order to prepare for the next market move takes on secondary importance, you want to capture an illiquidity premium.

Say what? All this talk about rivers is fine but just what the Mississippi are you talking about Mr. Gross? Well let me break down these concepts into actual securities or types of securities that should float the fasted down our bond river of the 90’s.

Fast Floaters	**Dead Weights**
Financial Futures	Cash Treasuries of all maturities
Mortgages	T Bills and Commercial Paper
Privates or 144A's	Extreme Barbell curve structures
International bonds (at the appropriate time)	Zero coupon bonds
Yankees	Swaps
Corporates (at wider spreads)	Noncallable securities
Callable securities	

While there's not the space to write about all of them, I think you can see that each either fits or doesn't fit into the conceptual framework I've outlined above. Cash treasuries are dead weights for instance because of their low yields and their high liquidity. The market of the 90's needs neither of those features. Financial futures are a much better alternative because they sell volatility via the implicit deliver options that are attached and thus provide a substantially higher yield. Yankees and international bonds are the sectors of the future because they provide much higher yields at various points in time of the world business cycle. Managers that used to shift between domestic utility and industrial bonds had now better look to swap domestic for international securities and vice versa when interest rate spreads dictate. Extreme barbells are out because they depend upon volatility, hold too much cash, and ultimately yield less. Swaps are dead weights because there are easier ways to employ the strategies of the 90's, and they always

were the “catfish” of the market – bottom fish, swimming near the leeches of the investment world that devise new ideas for one reason and one reason only – to generate commissions. And so on and so on.

All of these strategies reflect the fact that bonds are headed back towards Butler Creek. Without the turmoil of rapidly changing interest rates and economic conditions, excess returns of 100 to 150 basis points over the “market” will require new thinking and new tactics that continue to stress innovation as opposed to risk. Although the bond market stream for the balance of the 90-‘s will resemble that lazy creek of my boyhood days, swimming and flourishing in its midst will require a different mix of strokes and a mental framework that has never been employed in the modern era of active bond management. Our PIMCO swimsuits are on though and we’re ready to take the plunge. Hand me that vine will you? I’ll just grab hold here, swing out over that pond and let go into those refreshing waters of Butler Creek.

William H. Gross
Managing Director

The Story of How I Was Scalped and Lived to Tell the Tale

Investment Outlook - July 1995

They say, “you don’t know what you’ve got until it’s gone” and I can swear to that in spades, or in this particular case – in blades. Hair has always been a particularly sensitive topic with me – probably because there was a long time when I never had any, and then a stretch when I had a lot, and then a time when I didn’t, and then… well, perhaps I should let the story speak for itself. “Hair today – gone tomorrow, ” would be an appropriate summary, but there’s fun in the telling and maybe a moral or two for anyone who cares about their hair as much as I treasure mine. The fact is, I never really had any hair until I was 18. I grew up with a flat-top and lots of butch wax, the skinniest kid with the shortest hair in the 1950’s. Scissors were never the tool of choice for my barber, the blades just couldn’t get that low and the only option he ever had was to ask me if I wanted to leave a little “sideburn” – a question put to me endlessly and one which I must confess I never did really understand until I was in college and in charge of my own hairdo for the first time. What a joy it was to have hair, and lots of it! I can remember standing in front of the mirror late in my freshman year and declaring myself the “hair god.” It was long and thick an ready for those girls to run their fingers through, if I could just get up the courage

to ask one of them out on a date. The Beatles were invading the States and I was intent on being the first on campus to out-Ringo, Ringo. Or maybe it was Paul. No, Ringo, I was never that good-looking.

It was not to be. Early on a Saturday morning while driving to pick up donuts for that day's fraternity rush, I skidded on a downhill snow-covered road, plowed head-on into an oncoming car and went sideways into my windshield on the passenger side. You never feel a thing, they say, and it's true, but I was bleeding profusely and as I staggered into the emergency room of Duke Hospital, which just happened to be two blocks down the road, the look on the nurse's face told me I was in deep trouble. "Let's have a look, " the doctor said calmly as they stretched me out on the gurney. But it was then that he lost all composure and issued what has to be the all time classic bedside manner blunder. "Son, " he whispered gravely, "there's not a thing I can do for you." This was not exactly my idea of going out with your boots on. I probably didn't have much blood left, but I didn't feel like I was dying. What was it that he and the nurse had seen that had led him to such a grim conclusion? "You see, " he said, "you've lost the top of your head, and I have nothing to sew back on. If someone could go back to the accident and..., " the doctor was cut off in mid-sentence. I, feeling like General George Custer, had just about resigned myself to joining the hair fairy in the sky, when in walked a blessed highway patrolman holding my scalp by the tips of

his fingers. “Does anybody need this, ” he asked? (God’s truth – I was not fantasizing) “That’s just what I need, ” the doctor exclaimed, and the rest is, I suppose – history. After two plastic surgeries those golden locks grew back, but only in time to have them shaved off again as I crashed into a hell of another sort – Marine boot camp. Three years in the service kept it short, then it got long again, and now – well as any 51 year old man knows, you fight to hold on to every blade you’ve got. You’ll pardon me, though, for being extra sensitive. Dead men tell no tales, and not many scalped ones do either, but I’m living proof it can be done. Just don’t be asking me when I’m gonna get a haircut. I know you’ll understand.

Speaking of getting scalped – with the long bond down 5 points since I returned from my vacation last week, the bond market appears to be a candidate for the emergency room as well. All of this, too, on the heels of our bullish secular outlook, a prominent “print” in Barrons, and the ebullient hopes that naturally accompany such public pronouncements. Although that was a secular outlook and this is a bit more ephemeral, our optimism remains undiminished. The fact is, if Alan Greenspan thinks the worst is behind us, and if Vice Chairman Blinder thinks he won’t be voting for additional Fed Fund cuts any time soon, then that’s all right with me. As the Fam oil filter man says – “pay me now or pay me later.” Because what both of them appear to be saying is that the Fed will be content with 1-

2% economic growth, that the soft landing is here and they're not going to be doing anything about it. Fine! What more could a bond investor really want? Productive capacity growing by 4-5% a year, unemployment inching up to 6%, wage growth well contained and set to move lower, foreign trading partners headed into a slowdown of their own, domestic growth lower than potential and our central bank decides to sit on their hands. Please, please Brer Bear, don't throw me in that Briar Patch. I'm not sure the bond market can survive the pain!

Well, of course it can. It is, in fact, a short-term glimpse of our long-term secular scenario unfolding before our very eyes: reluctant central banks, hesitant to ease monetary policy until it becomes more than obvious that the domestic economy needs a jump start in order to return to 3% real growth. What that delay produces, of course, is continuing slow monetary growth, an even "softer" soft landing, and 2% inflation a year down the road. Bonds will thrive under such a scenario, especially after having backed up to 7% over the past few weeks. This is a bond investor's dream, an opportunity not to be missed. How do we at PIMCO intend to take advantage of it?

The first thing a good bond manager thinks of under such circumstances is extending duration. If the "market" has a typical duration of 4¾ - 5 years, then we want to be longer. As you know, the PIMCO investment philosophy can allow duration to move as high as 6 years during secular and

cyclical bull market phases and we'd like to inch closer to that target as the summer advances. Secondly, we'd like to lessen our mortgage exposure and own more non-callable government bonds. One of the positives of this recent setback in the market has been the relative outperformance of mortgagees as prepayment fears have been modified.

Mortgages, in fact, in the midst of a year during which interest rates have declined over 100 basis points, have somehow managed to outperform Treasuries. Quite remarkable indeed, and if the outlook is for even lower yields ahead, there's no point in pressing your luck. We'll still hold lots of adjustable rate mortgages as proxies for Treasuries on the short end of the cure but the 30-year variety with fixed coupons are sale candidates on continued strength. Corporates? Spreads are still too tight, except for those high yielding types in the Ba category. By the way if you haven't taken a look at PIMCO's Ben Trosky and his high yield fund for a 5% position in your portfolio, you should. His numbers are at the top of the chart and he worries more than any portfolio manager in the business, with the possible exception of Marty Zweig or yours truly. We don't call him Mr. 10K because of his salary. We also continue to simply adore (stronger than "like, " less than "love" since you never want to fall in love with any of your investments) German Bunds with yield spreads at 50 basis points higher than their U.S. counterparts. After hedging the currency back into dollars, that yield spread widens even further.

With higher interest rates and the security of the world's tightest central bank behind them, German Bunds are a can't miss candidate over the next year or so. We've also got the benefit of Lee Thomas, our International Portfolio Manager, who's turning out to be one of the best acquisitions since the Lakers got Kareem from Milwaukee.

Well that's the short list of our investment strategy over the next few months: lengthen maturities, sell mortgages, continue to own high yield and German Bunds. By the way, those Mexican and South American Brady bonds we touted so highly in February have done very well and still look good. Whatever the case, have yourself a nice August vacation. I've already had mind, I'm well rested and ready to make money. Now if I could ever find some time for that haircut appointment. On the other hand, what's a few more weeks for a guy who's out Custered-Custer, if not out Ringoed-Ringo.

William H. Gross
Managing Director

Mr. Lynch, I Presume

Investment Outlook - June, 1997

Not everybody wants to write a book, but if not, they should at least go on a book tour, because I've found they're worth their weight in laughs and a hefty dose of self-analysis on the side. New York's Barnes & Noble was the scene of my own comic relief this past May, as I presented the story of Everything You've Heard About Investing Is Wrong! to an overflowing crowd of 20 seemingly interested listeners, and then began to sign away à la Stephen King. Signatures are one thing, but I must say I never understood the power of the come-on phrase on the book's cover, "The Peter Lynch of Bonds, " until the moment when an elderly lady approached the front of my table with book in hand and declared: "Mr. Lynch, you never should have let that Robert Vinik take Magellan away from you. Those bonds are no good and never will be. The shame, the shame for a fine young man like you – what on earth were they thinking?" Well now, I thought. How do I ease myself out of this one? Does this lady really believe Peter Lynch has a mustache? And didn't she just hear me extolling the virtue of bonds for the last 20 minutes? I quickly decide the answer was "yes" on the first count and "no" on the second and quickly signed, "Best of luck in the markets – Bill Gross." The more appropriate message would have been, "Best of luck for the

rest of your life – I think you'll need it, " but there wasn't enough room on the page and I didn't have the heart.

Shortly thereafter, a 30ish-looking broker walked up and after telling me how he'd been following my career on TV and in the press said, "you've been so successful Mr. Gross, why don't you quit?" Semi-stunned by the abruptness of his query, I frivolously shot back – "I don't know; I guess I'm afraid to stop." Up until that point, my personal explanation had always been the daily excitement and the need to play little kids' games in a grown-up world, but upon reflection later on in my hotel room, I had to admit there was something to the "fear" aspect of it, not only for me, but perhaps for some of you as well. I remembered my daily noontime "runs" back in Newport Beach, when halfway through and feeling the urge to stop, I shook it off with the fear that if I did it once, I'd do it again and again, until at last there'd be no running and finally no "me." The fear of a mercurial "me" and what it might resemble in a PIMCO afterlife is something I decided I'm not ready for at the moment, and perhaps may never be, but it took that gutsy broker and a whistle-stop book tour to help me figure it out.

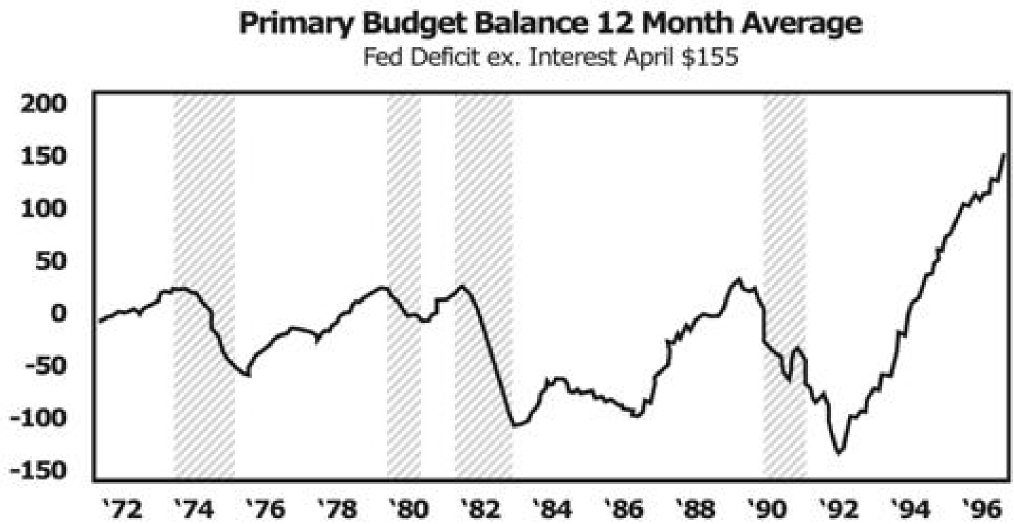
As I was just about to leave the store, an elderly gentleman almost bowled me over in a rush to get to the staging area where I had just finished my presentation. "Is Peter Lynch still there?" he gushed. Floored for the third time in one afternoon, I was about to count myself out on the basis of a Fidelity TKO, but with the heart, if not the

mind, of a heavyweight champion, I quickly picked myself up off the portfolio manager's deck and said, "No sir, he couldn't make it today, but he left a message for us all: Buy stocks of companies that you know, stay fully invested, and keep as far away from bonds as you possibly can." As I walked through the door onto Madison Avenue, I swear I heard a soft voice whisper in my ear, "Well done, Mr. Lynch, well done." But being a bond guy and still groggy from my knockdowns, I quickly dismissed the notion as sheer fantasy and headed towards the corner hot dog stand for some immediate back-to-earth relief.

We've had a healthy dose of relief in the bond market these past few weeks and the headlines have attributed the lower yields to slower economic numbers and the near disappearance of inflation on both the retail and wholesale sides. There's no doubt that these are the primary factors that move bond prices, but there are times when an analysis of good old fashioned supply and demand come in handy as well. PIMCO, for instance, has in the past analyzed long-term secular changes in the demand for funds that have come about via the opening of Eastern Europe and the development of emerging markets. We've also reported on the continuing trend towards fiscal conservatism in G-7 nations and the dampening effect that has had on the supply of bonds throughout the world's more mature economies. But rarely have wee reported on the rather dramatic change in the supply/demand equation for U.S.

bonds in isolation. And it’s this change, almost as much as the economy and inflation, that has led to better days for bonds in June of 1997, and that promises even better times ahead as we move into the year’s second half.

If my memory serves me correctly (and it rarely does these days), it was Stanley Salvigsen, formerly with Merrill Lynch and Comstock Partners, that first envisioned the day when there wouldn’t be enough Treasury bonds to go around. That was in the early 80’s, but Ronald Reagan’s budget woes quickly put an end to that notion, although the concept has been intermittently revived ever since. Now, however, with the U.S. budget deficit at close to $70 billion and 1% of GDP, it appears that “Salvigsen’s Folly” may turn out to be as serendipitous as that of Seward himself when he purchased Alaska back in the 1860’s. $70 billion dollars of red ink implies, of course, that the U.S. will need to borrow approximately $70 billion in fiscal ’97 to pay its bills. The deficit and borrowing requirements are not totally 1 for 1 because the government can sell assets and the politicians can distort the cash flow requirements, but you get the picture, I’m sure. What is not so immediately obvious is that from a supply/demand standpoint we may not be running a deficit at all, but in fact enjoying what is known as a “primary” surplus. The chart below shows the snake-like trail of the “primary” budget; that is, the budget when interest payments on prior debt have been subtracted out.



It's true that interest on debt is a legitimate expense and a valid part of the deficit, but the fact is that most of it is plowed right back in to the purchase of U.S. Treasuries. Sure, mom-and-pop on Main Street may need their interest to pay the bills in retirement, but most holders of debt such as foreign governments, pension funds, and other institutional type accounts are in a cash flow surplus situation and simply reinvest their coupons into the market. That means the $200 billion dollars in interest payments this fiscal year are basically not a part of the deficit when viewed from a supply/demand standpoint. Instead of a deficit of $70 billion, the U.S. is running a primary surplus of $130 billion.

Think what that implies. It suggest that the Treasury is issuing debt much like U.S. corporations issue stock, and that the "under the table" its holders are using the "profits"

or the interest to buy back all of it and then some, just like corporations are doing in today's equity market via stock buy-back programs. While the deficit is still increasing, it's obvious that it's not expanding enough to meet the needs of its existing holders. There appears to be a shortage of Treasuries, much like Salvigsen foresaw back in the 1980s.

This shortage is most immediately apparent in the Treasury Bill market, where the net issuance of Treasury Bills is actually shrinking. Since foreign central banks and other conservative buyers purchase Bills almost exclusively, and because their purchases have been increasing dramatically over the past several years, the yield on 3- and 6-month paper is trading well below the yield on overnight Fed Funds established by the Federal Reserve at 5½%. As a matter of fact, 3-month Bills at 4.95% are barely yielding more than a passbook savings account at your local bank. That low of a yield for active managers such as PIMCO, with a positive outlook on the market and a Butler Creek style of investing, signals just one thing – extending maturities to pick up more yield. And that is why two-year Treasuries now yield 6% without an immediate prospect for lower Fed Funds and why 30-year bonds yield 6.7% under the same circumstances. In addition, the longer parts of the yield curve have their own reduced supply to contend with. The Treasury, for instance, has just canceled a quarterly issuance of ten-year notes that the market had adjusted to with higher yields. Now, the situation is reversed. The supply squeeze is on, and as long

as the economy continues to slow and inflation remains benign, we'll witness a better tone to bond market over time.

The bond market's prospects, while excellent, come nowhere close to the recent results sprouting out of the equity turf inhabited by my namesake Peter Lynch. But that's a story for another Outlook and perhaps another book. If we're to get those 8% equity returns over the next several years that my book suggests, then the stock market had better slow down real soon or I'm going to have to re-title my existing one. I've been thinking something along the lines of Some of the Things I've Heard About Investing Are Wrong!, but then it's a long distance race and the day is still young. For now, put at least a few of those dollar bills in the bond market based upon an increasing shortage of government bonds. If I'm wrong, I just may shave my mustache after all and join Peter, at least in spirit, over in his equity wonderland.

William H. Gross
Managing Director

BOYZ II MEN MEN II BOYZ

Economic and Market Commentary - August 1, 1999

Recognizing the little boy in a grown man is not always an easy task, although most of us, especially the men and their wives, I suppose, know that he's always in there somewhere. Despite the ties, the shaving lotion and the false bravado made necessary by our competitive world, snakes, snails, and puppy dog tails are what they're really made of. My favorite "little boy becoming a man" story has always been about my son Jeff, who is now 27 and long since on his own. He was a five year old in 1977 and being prematurely pushed into Little League by his ambitious and vicariously proud father. Before his first official time at bat and while waiting at the on deck circle, he intently observed the current batter who, as fate would have it, was a lefty, and batted from the right side of the plate. When it came time for Jeff to hit, he used the image and example of the last person he had seen and walked up to the right side of the plate as well. My son, however, was a right-handed batter and by so doing, was now facing the rear of the batting cage instead of the opposing pitcher 45 feet away. For what seemed like an eternity, Jeff continued to face the back of the cage, frozen into inaction by his obvious nervousness and lack of experience in the grown up world of

Little League baseball. It was only when his coach came over and picked Jeff up at the waist, turned him 180 degrees in the air and cried “play ball” that the stands let out a sigh of relief and a hearty round of applause. His Dad, of course, was mortified—being the budding example of a worldly raconteur. He hadn’t remembered ever making a mistake like that, even at five and certainly not in 1977, ’87 or ’97 for that matter as the years moved on.

Cut away to June of 1999, for an example of how a man—a sophisticated raconteur— can become a little boy under the same circumstances of anxiety and intense social pressure. Yours truly had been invited along with his wife to visit the home of Bill and Melinda Gates for an evening of cocktails, dinner, and conversation culminating in what would presumably be a check written at a later date to a most worthy philanthropic organization. I mean, come on now, how many of you, aside from the debatable amount of the check, would pass up the opportunity to see that home and gab with the world’s richest and perhaps most interesting couple? Not me. Not us. Down the stairs we strode, perhaps the most impressive entryway to a private residence ever built outside of Buckingham Palace or Versailles. Four stories of descending steps, perhaps a hundred yards in all, flanked by video screens of ever-changing images of art —Monet, Renoir, Picasso—all before you reached the main foyer. Once there, we were enjoined by receptionists to discover the rest of the home—modern in

architecture, comfortable in space and style. My favorite was the trampoline room, but the library, displaying Leonardo Da Vinci's "Codex" as well as a gorgeous Winslow Homer oil was not far behind. Finally we turned the corner of the family room and there they were—Bill and Melinda that is—receiving what appeared to be only one or two couples and having a brief conversation with both. This was our chance for glory. First the house, now them—wow, what an evening!

Ah, but here's where my story about Jeff and his first at bat come into play. As fate would have it again, the man ahead of us introduced himself as Mike "Something or other" and in my nervousness (I thought I was Mr. Cool) the name stuck in my mind just like the left-handed batter's position had stuck in Jeff's. As Mike and his wife moved on and Sue and I moved forward to the Gates, I stuck out my hand and said "Hello, I'm Bill Gross, it's nice to meet you, <u>Mike</u> ." Well, the look on Bill Gates' face sort of said it all, I guess, but for what seemed like the same eternity as Jeff facing the back of the batting cage, I mentally stuttered and stammered and said to myself, "How in the hell am I gonna get out of this one?" Thank God for my black tuxedo because my underwear seemed to be turning a distinct shade of brown. Finally I said "I……I mean —Bill." Like the little league coach, it was Sue who finally saved me, talking effortlessly about the house and golf and the things we shared in common. But the man had become the little boy—

of that there could be no doubt. Move over, little Jeff; after 22 years you've finally got company.

I'm sure you would have loved to have been a fly on the wall to observe the look on both of our faces during my humbling introduction. I too, would love to see the expression on yours, dear reader, as I suggest that our dynamic U.S. economy may soon be due for a fall as significant as the one my fragile ego took that warm Seattle evening; maybe not down to floor level, which would indicate a recession, but low enough to scare the living daylights out of those who are convinced our nearly nine year economic recovery will never die. It's hard to believe a forecast like that, I suppose, when it comes on the heels of some of the strongest economic reports of the year—a sizzling employment number, record levels of retail sales, an apparent revival in manufacturing, and an ongoing love affair with technological investment. But most of these economic stars are at the zenith, and there are significant countertrends which should sap the strength of the recovery going forward, allowing interest rates to peak near current levels and eventually move lower.

One of the most obvious trends that should weaken the U.S. economy has been the direction and level of bond yields themselves. Investors are most aware of the behavior of U.S. Treasury notes and bonds. It was only 10 months ago that rates bottomed at 4¾% for long-term Treasuries, but those yields are now 150 basis points higher at 6¼%. If

government rates are up by 1½%, however, corporate and mortgage yields have climbed by even more—most by nearly 2%. Today, a potential home buyer is staring an 8% mortgage in the face, instead of a 6% payment less than a year ago. Similarly, even high quality A and AA rated corporations now pay in excess of 7% for their intermediate and long-term debt. The private sector's cash flow, then, is being absorbed much more quickly than before. Home buyers, and home owners through potential refinancings, will now have a lot less spare change to purchase new cars and discretionary big ticket items which have been the hallmark of this recovery. Corporations, in turn, will be less opportunistic in their ability to invest in new plant and equipment because higher interest rates will soon begin to eat into their profit margins.

The profit analogy leads directly into my second argument for a significantly weaker economy, one which I warned about in recent Investment Outlooks but which now appears to be finally coming true: lower stock prices. Without stock market capital gains and the wealth it has generated in recent years, the economy would only be 2/3 as strong as it currently is. Perhaps as much as $100 billion of annual consumer purchasing power has been made possible by the market's 20 to 30% annual profits during the decade of the 90s. Investors, consumers, and the economy have come to depend on the market in recent years, and the trend has become habit forming, much like a junkie

addicted to heroin. My sense is that the consumer will shortly be forced to start using methadone, and while the withdrawal may possibly be orderly and painless from a recessionary point of view, the old heroin highs are a thing of the past. Take a look at the following PIMCO chart displaying the correlation between U.S. equity prices and changes in personal consumption. While the correlation is not perfect, it's high enough to tell me that a downdraft or even a leveling off in stocks will likely be followed by a decline in the growth rates of consumer spending. Notice that the recent climb to 5% real consumption growth has occurred during a period in which stocks spurted to historic year-on-year returns of 35%. During periods of much smaller stock gains, the growth in consumption was a more stable 2–3%.

If stocks stay at current levels (10–15% off their highs), then consumption and the economy will undoubtedly lose significant steam.

To this list, I would add a third contractionary factor—the recent rise in the consumer price index, particularly oil prices. If motorists are spending more at the pump than they were six months ago (20–30 cents per gallon) then they'll have less money to splurge at the movies or the mall. With commodity prices up sharply over the past six months and inflation approaching 2½% annually, consumers have got to be feeling a little less flush than they were at the start of the year. The economy should slow.

And last but certainly not least, is Super K, or Y2K as we've all come to know and love it. No matter whether it's a fact or a fantasy, a catastrophe or a chimera, there's no doubt that businesses and even some consumers have spent a combined fortune trying to avoid a millennium hangover come January 1st, 2000: hundreds of billions, in fact. And almost all of that spending is just about over and done with. Sure your Y2K compliance officer is still reporting to work and answering form letters from other businesses in order to avoid potential lawsuits, but the heavy lifting is over.

From now on, those tens of billions of dollars per quarter that have been spent to avoid a technological calamity will just not be there anymore to stimulate the economy. And that says nothing about the potential negative effect on small businesses if Y2K is for real; and so on and so on with a host of other Armageddon- type hypotheses. The sum of them all, is that Super K had been super for the economy but will now extract a payback in the form of weakness, not strength.

For several years now, in fact for much of the decade of the 90s, the U.S. economy has taken on the appearance of a healthy, vibrant, super-sophisticated raconteur— impervious to the foibles of its bumbling economic trading partners. It's stepped up to the right side of the plate à la Mark McGwire and knocked homer after homer deep into the outfield bleachers. It's courted the company of billionaires with a

swagger and a confidence that screams "I'm the man." Ah but now there's a change in the wind. I think Americans are about to meet "Mike Gates" and suffer a bit of a comedown. Boys become men. Men revert to boys. Economies are no different. The slower economy should halt this mini-bear market somewhere close to 6 ½% for long U.S. Treasury bonds, and allow for positive returns for the bond market from the fourth quarter onward.

William H. Gross
Managing Director

Half Brainer

Investment Outlook - November 1, 1999

There was a pretty good Steve Martin movie in the early 90s entitled The Man with Two Brains. I've always remembered the title because at the time, I thought that his character probably had four times as much gray matter as I did. Now as you've probably already computed, 4 x 1 normal brain = 4 brains not 2, so the correct mathematics must imply I have half a brain which, as it turns out dear reader, is the frightening truth. Not to imply that I'm a nitwit or anything because I am actively involved in managing your financial nest egg, but brains, as I've learned, are divided into left and right hemispheres. A recent MRI scan, though, verified that I have absolutely no right side to my apparently otherwise normal brain. After viewing the initial image my startled nurse appeared on the verge of calling 911 or using one of those secret paging codes like " Dr. Death to the X-ray room stat." I quickly told her, however, that this was what I had suspected all along – that in fact I have no right side to my brain: can't draw, can't paint a picture, coloring within the lines is an excursion in total futility. This I know is hard to fathom, but as further proof, my self portraits have never really progressed beyond the level of stick figures, and to this day, I still have to be reminded to give them fingers and toes.

Imagine, then, the jealously and envy I harbor for all of you with two complete halves to your brains. And imagine the feeling of right- sided impotence I have when meandering through an art gallery or leafing through one of those giant-sized art books lying on my family room coffee table that are really meant to impress visitors instead of frustrate me. Well, you need feel sorrow and empathy for me no longer, because while it's true that even advanced genetic biology will never be able to grow a half brain for me on the outside of a mouse or a dog or whatever, I have at least discovered a kindred spirit – a half brained twin who can't draw or paint either. And the most remarkable thing about my discovery is that this twin is (was) an artist – and a famous one to boot.

Yves Klein is the name of my half empty-headed friend and (1928-1962) follows his title on two spectacular pieces listed in a recent Christie's twentieth century art sales catalog. The "1962" points out I guess, that he's dead which is too bad, because it makes it harder to compare notes, but wow, I mean wow, this guy painted like I draw self portraits, and he got paid for it too! I present to you the first of his two images for your perusal and careful discrimination.

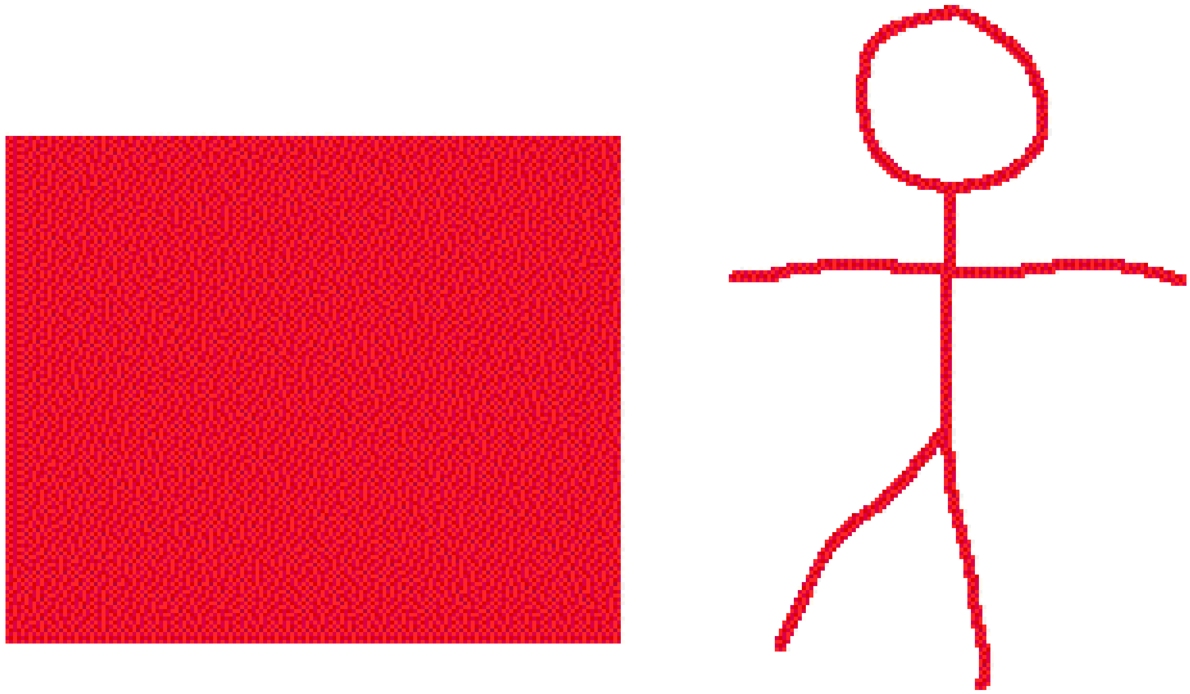
Title: IKB Artist: Yves Klein (French, 1928–1962)

This tour de farce was titled “IKB” and consisted of “pigment and synthetic resin laid down on panel” as Christie’s described it. 8 1/2 x 7 inches, too, which is important in the art world, but which in this case might be otherwise described as a tad “puny.” Nevertheless, it sold for $35, 000 because, I assume, Mr. Klein’s blues were the bluest of all possible blues. No elephant dung here, Mayor Giuliani! Just step back, your honor, and drool at the creativity of this canvas.

As further proof of the artistic ability of my half brained twin, I present for you another of Mr. Klein’s creations, the better known (17 x 14) piece entitled “IKB 121, ” priced at $150, 000 no less.

Title IKB 121 Artist: Yves Klein (French, 1928–1962)

Well now, if that's not the clincher. This guy was truly a painter extraordinaire. Mr. Klein, as it turns out, called himself "Yves le monochrome" and I can surely see why. When you've got a niche, exploit it, Yves must have figured. I can't pronounce French very well so when I try to reach my half spirit in séance-like dreams, I just address him as Mr. Blue. "Mr. Blue, " I ask, "where, oh where, in the art world is <u>m</u>y niche?" The following was his suggestion that I now lay before you for critical acclaim:



Title: My Niche Artist: Bill Gross

What I should have expected, I suppose. But as his ghostly voice faded into the distance for perhaps the last time, I heard him say – “I got a monopoly on the blue, kid. Why don’t you try red? And next time, don’t forget the fingers.” Half brain. Some kindred spirit, he was.

Oh, what should a nitwit write about this month, as he applies the functional left side of his brain to the current state of the investment markets? So many topics, so little time as the saying goes. Being a bond guy, I am prone to see those topics as drinking glasses that are half empty instead of half full and to expect Goldilocks to wake up any time now from her temporary nap, instead of sleeping through the night, filled with sugarplum dreams of

productivity miracles and escalating NASDAQ capital gains. That expectation, in addition to my empty right-sided brain, I suppose, is my professional handicap – so you should take that into consideration as you analyze the following. But it seems to me folks, that this state of nirvana can only keep going for so long. For despite the positive impact of technology on our economy and financial markets, almost all of you with commonsensical left-sided brains must know that we have a bit of a Ponzi-scheme going here: at least some of our prosperity is based upon prosperity itself. A very FDR-ish thought, don't you think, but perhaps just as relevant today during years of plenty, as was Roosevelt's during times of despair. It's another way of saying that the market "tail" is now wagging the economy "dog" instead of vice versa. We must have double-digit gains in stock prices in order to support existing levels of consumer and investment spending. We must have more and more Cisco's in order to maintain foreign sponsorship of a grossly overvalued dollar. We must have red hot IPOs aplenty in order to divert serious analysis of a current account deficit that now exceeds 4% of GDP and which would be viewed as an emerging market Achilles heel were it not for the fact that our stock market makes such concerns disappear. Poof! If Christie's could convince someone that "Yves le monochrome" was a distinguished artist, then I suppose a throbbing stock market can be enough to convince most of the world that all of this can continue indefinitely. It can't.

When the music stops, nobody knows, but it will stop, and for legitimately left-brained reasons.

Ponzi's scheme, you'll remember, collapsed at a critical point when the inflows he was using to pay for the outflows were just not enough. Word spread that a few investors were missing their monthly interest payments, which led to withdrawals, further cash flow squeezes and ultimate collapse. Now, the U.S. economy and its stock market is not a Ponzi-scheme. People are working hard and working smart and we <u>are</u> in the midst of a technology boom. But there are Ponzi-like elements in the current environment which could stop the music quite abruptly, the major one being the stock market itself. When it stops going up at the rate investors have grown accustomed to, then the process reverses and the headaches begin. Note that the prior sentence didn't even talk about the stock market going down. All that is needed to set off that initial spark is for the market to disappoint expectations.

Take a look at the following chart for an explanation why.

Private Net Savings as % of GDP

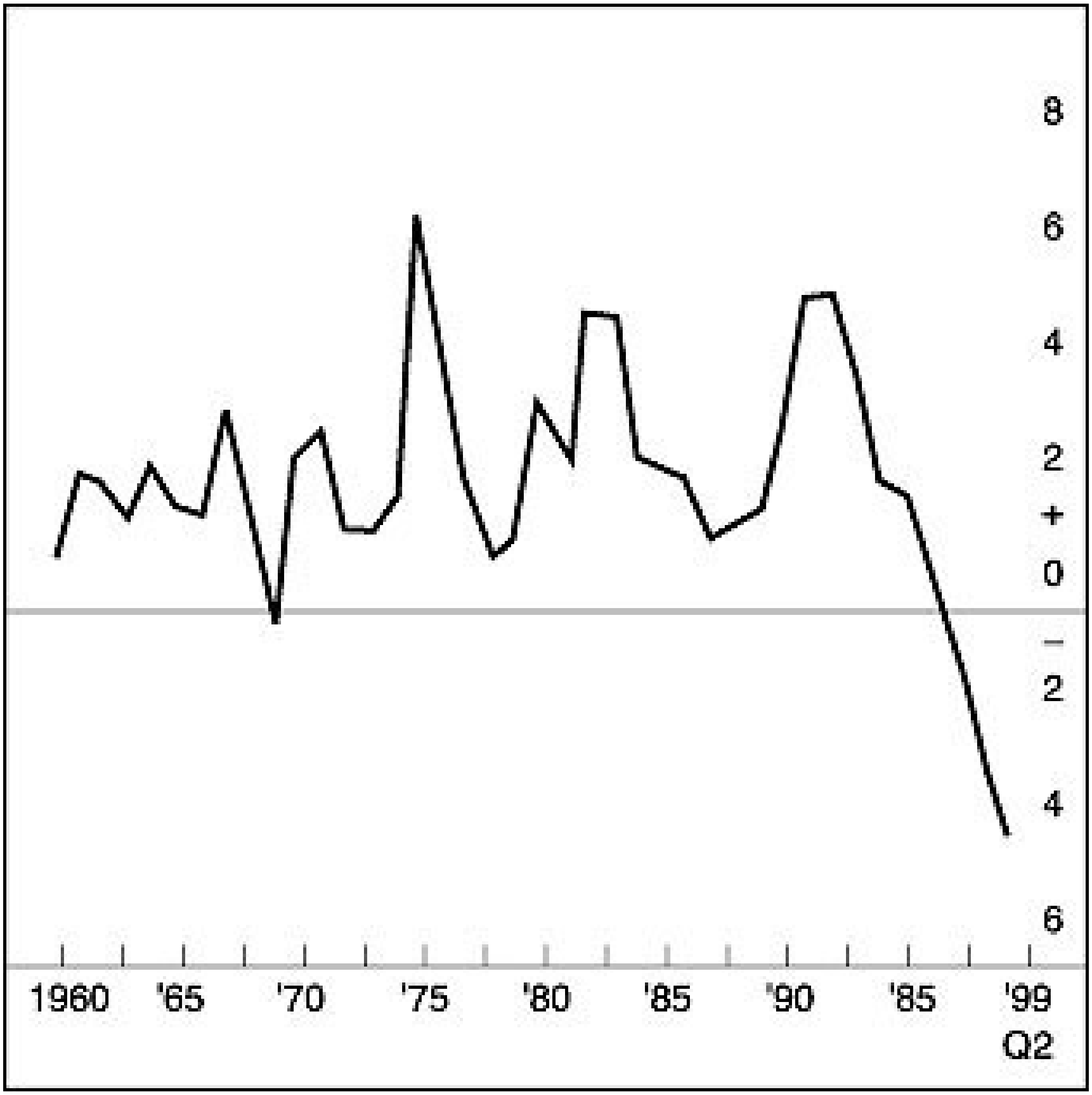


Figure 1 Source: Bureau of Economic Analysis

This graph displays private net saving as a % of GDP and at first blush may seem to have little to do with stocks themselves, but the two, it turns out, are linked at the hip, and have as high a correlation as Klein's "IKB" and "IKB 121." When private net savings falls abruptly into the minus

column, as it recently has for the first time in over 50 years, it means that spending is exceeding income. In 1999, U.S. consumers are spending nearly 5% more than they earn via wages, dividends, and interest on their investments, the difference being provided by increased debt and realized capital gains which are not considered to be part of net savings. Now here's the critical rub. Some will claim that capital gains are as sure a thing as the sun rising in the East, and that has surely been true. If so, then maybe we should mentally adjust savings, and therefore spending assumptions to reflect a more modern, realistic attitude. Well, maybe. But even so, unless stocks keep going up at the same rate as they have in the past – unless capital gains keep accumulating at the same double digit rate they have in recent years, then the growth rate of consumer spending will fall, the growth rate of profits will decline, and the growth rate of the economy itself will slow down. An economy that feeds on capital gains must cool off if those capital gains do the same. Our prosperity, to return to the same phrase, depends on prosperity itself, and at least some of our prosperity depends upon a booming stock market.

History shows that the current state of affairs cannot continue indefinitely. Other countries such as Britain and Japan in the late 80's, have experienced the same negative net savings trends as seen in Figure 1, which were really glorified spending binges based upon asset bubbles. When

the bubbles stopped expanding and eventually popped, the savings rate returned to the plus column, slowing their economies and eventually producing serious recessions. Recession need not be the eventual outcome here in the U.S. as we approach the new millennium. We could back off gently as is Greenspan's hope and intent as he tries to slow the stock market down. But much of the ultimate conclusion rests not just in his finely skilled hands or acutely tuned left-sided brain. Because we are spending so much, foreign investors in dollar denominated stocks and bonds have a big vote in deciding the verdict - they hold more and more of the IOUs. If they decide to cash them in rather abruptly, as opposed to accumulating them at a pace reflective of our spending habits, then the dollar will decline, inflation will rise, Greenspan will raise rates, the economy will slow. Why would they ever cash them in? Lots of reasons, but as this Outlook suggests, a faltering stock market leads the list. Without a prosperous stock market, it all can come undone rather quickly.

So here's to stocks, and here's to the good life based upon escalating capital gains. As long as they continue to go up at 20% annual rates, Uncle Ponzi will have enough cash to keep the good times rolling. If they don't, well, as P.T. Barnum, Ponzi, and Yves Klein knew, there's a sucker born every minute and someone willing to take his money as well. PIMCO's money continues to be directed into high quality areas with an eventual expectation that yields will or

have peaked in the 6 1/2% area for long U.S. Treasury bonds. Those expectations, while uncertain on timing, are conditioned upon the ultimate exposure of our Ponzi-like prosperity for what it is: Part real, part illusionary, but certainly not monochromatic or even monolithically destined to continue at the same pace forever. “Yves le monochrome” would surely be disappointed. Until next month, so long –

William H. Gross
Managing Director

Ticker Tape Charade

Investment Outlook - April 1, 2011

I went home from my busyness
and later to dream that on a
street named Wall there were
miles of ticker
floating like
a river with
no end;
stocks
nurturing new
business,
funding fresh ventures yet ultimately awash
like flotsam – trading endlessly between random
hands, signifying little beyond this or that
turn of the cards, beating the Street for now,
yielding to it thereafter.

For the market's magic
consisted primarily of hope –
a smiling phantom this,
such that whoever reached for it
touched only meager dividends and
eventually plead with not a small
amount of guile

"take these shares off my
hands at higher prices, oh
future generation of
players.
You are my
salvation, my
pawnbroker, my
source of
ephemeral wealth."

Ok, so I'm no Robert Frost. Still, it's a lot easier to write a poem about a neighbor's fence or a snowy meadow than the stock market. If Frost had thrust his quill in the direction of Wall Street, perhaps he would have become "onomatopoeia" challenged just like yours truly. But "Ticker Tape Charade" is about as close as I'll ever come to waxing poetic and so I like it. It's sort of like my wife Sue's recent interest in painting. Seeing a *New York Times* article on a $15 million Picasso sold at Sotheby's, she exclaimed "I can do that for $29.95!" The Earl Scheib of modern art, I guess. And so she did. Her paintings now adorn the walls of our kitchen and will soon spread like the Mad Cow into our living, family, and bedrooms before it's all over. They're not Picassos, but they're good and she likes them. Same thing for me. It's not Frost, but it's good and I like it.

Perhaps more importantly, my poetic "Charade" makes a point – a controversial one I'm sure – and one that most

naturally would be made by a curmudgeonly bond manager such as myself. The point, quite simply, is that equities as an asset class are not all they're cut out to be. While their issuance via IPO and secondary distributions facilitates and indeed fertilizes economic growth, their value in recent decades have depended less on the cash flow an investor received via dividends and more on a succession of gullabaloos who believe that stocks always go up.

They do not. And if (up until May of 2000) they <u>have</u> for a good 20 or 50 or 100 years, then their more recent rise has at least in part been based on hope as opposed to an actual return of cash flow or capital from the companies themselves.

I recognize I am in heretical almost blasphemous territory here, and what could be worse than a blasphemous poet; Allen Ginsberg vs. Robert Frost, I guess, which isn't much of a contest. But I'm going to offer up some statistics and a few examples which may at least get you to thinking about the subject and that, after all, is what poets are for.

My tale of equity woe owes credit at least in part to a curmudgeon even more curmudgeonly than myself – Jim Grant. At times I've criticized his market timing but never his intellect, writing ability, or historical financial foundation. The man knows how to tell a story, even if it's sometimes flavored with nattering, nostrums of negativism. In his book, *The Trouble with Prosperity*, Grant relates the history of Robert Lovett, a partner with Brown Brothers, who in 1937

wrote an article in *The Saturday Evening Post* criticizing the belief that stocks (and many bonds) should be locked up and held for the long-term. Although influenced by the Depression, Lovett wrote that “Perhaps we have seen enough by now to concede that no investment is safe or unchanging enough to ‘put away and forget, ’ as one is frequently advised to do in periods of rising prices.” In support of his conclusion, Lovett pointed to the startling rate at which the most prominent companies of the prior 35 years had reorganized themselves, declared bankruptcy, or ceased to pay dividends. Rather than using an index, such as the Dow Jones which assumed away corporate mortality by replacing a fallen company with a new freshly scrubbed face, Lovett tracked the 20 most active stocks of 1901 and the 20 most active bonds and followed them through their ups and downs over the next 35 years – a period by the way, which included much more prosperity than economic calamity. Assuming all dividends and interest were spent when received as opposed to compounded (not a bad real life assumption these days outside of 401K land) Lovett found that the most popular stocks had shown a shrinkage of 39% in terms of market value over those 35 years while the bonds had lost 4%. Lovett writes:

After having his capital at risk for 35 years of enormous industrial progress and national growth, our investor would show an aggregate loss of about 25 percent. And one out of

four companies in the bond list as well as the stock list would have gone into bankruptcy.

Grant then follows with his own corporate coup de grace. “The crux of (the argument) was that capital in capitalism is consumed, not conserved or compounded, (and) the fundamental reason for capital attrition is that businesses are mortal.”

Cut to April of 2001. I couldn’t do a 35-year study of the most “popular” stocks in 1965, but I did find out that 1 of the 30 Dow stocks in ’65 did eventually go bankrupt (Johns Manville) while 10 have disappeared via acquisition. Since we haven’t had our depression yet and almost certainly won’t anytime soon, the corporate attrition Lovett warned about over our now modern period was almost undoubtedly less. Still, Lovett’s study (and even my modern update) was a reminder that corporations disappear and that holding a stock for the long-term can be dangerous. Doing a Rip Van Winkle on the likes of Cisco, Intel, Dell, or any other “popular” New Age Stock, then is not a strategy to be followed by the faint of heart or even the sound of mind.

But there’s more here than Lovett pointed out and thank goodness for that. I can’t waste my poem pointing out what’s becoming obvious – that some popular companies go belly up. What I’d like to point out is that many companies and even some industries never wind up paying the investor much in the way of dividends even if they don’t disappear. And if you believe as I do (as well as most theorists and

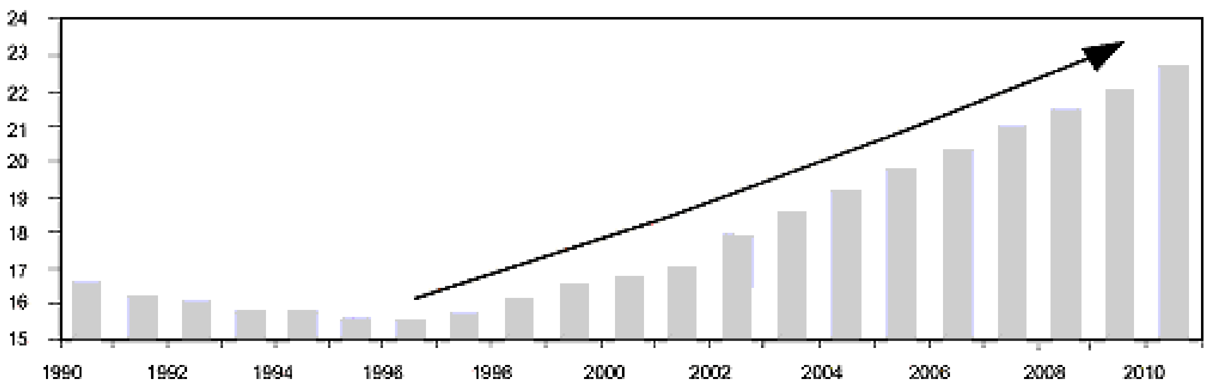
academics) that if a company never pays a dividend, or at least not much of one, that its stock price should approach zero rather than par, then much of what we call the stock market is really just a mirage. I called it a “smiling phantom” in my poem, but it just as easily could go by the name of Blanche Dubois in another figurative setting with the allusion that stock prices depend on the kindness and ultimate takeout by strangers.

These overvalued companies and industries I refer to tend to occupy sectors that are capital dependent – so thirsty for capital, in fact, that they can’t return any of it to their stockholders. That thirst, in turn, is almost always ongoing, and nearly perpetual in nature. Still it’s not enough to criticize a company/industry because it needs money. That, after all, is why we have stocks in the first place. But if, due to constant innovation, these companies need more and more money to remain competitive or even stay alive, then stockholders are usually the last in line when it comes to receiving a dividend or a return on their investment. I call this phenomena “cigarette butt capitalism, ” because with these companies, the cigars and fresh packs of smokes are used up by their “shadow” equity holders and indeed the ultimate consumers of the company’s product. Public stockholders are left with the butts.

Let me elaborate via example. The U.S. airline industry is in many ways a mirror image of the Internet. Subsidized by the government early on via its role in delivering airmail, it

expanded and innovated much like the Net has done in its few short years. It may seem like things have gone from bad to worse in terms of service, but the 707, the 747 and now today's modern fleet are really miracles in terms of productivity and technological progress. All of that progress, however, has required money – constant flows from depreciation as well as fresh lending, such that over the years the industry has paid little if any dividends. Are you aware that the airline industry has still not recorded a collective cumulative profit over its entire existence? Did you know that the industry leaders have paid only minimal sporadic dividends during the last 35 years and not at all since the late 1980's? How can you value stocks like that? On the hopes that someday they just might – pay dividends? No, common sense would suggest otherwise. Their planes are in fact mortgaged to the hilt and the only real equity returns accrue to "shadow" equity holders such as GE Capital which assume the equity portion of individual airplane leases. Passengers, as well, benefit enormously via cheaper fares and faster planes, but it's the stockholders that get the "butts."

Older Investors (55-64 years) As Percent of Total Investors



Source: Barclays Capital

Using the airline industry as a straw man looks like an easy crutch until one recognizes that today's telecommunications industry may be in much the same pickle.

Forced into massive expenditures for licenses and technology in order to survive, dividends are being reduced and in some cases eliminated. Their common stocks which once steadily appreciated on the basis of fair and consistent regulated returns are now moving downward at a steeper slope than the rest of the pack in an uncertain, more competitive, deregulated economy. They are not alone in their quandary; they are just the most visible. Any company that must innovate via massive capital expenditures as opposed to people or R&D is especially vulnerable. They just can't afford to give much of their returns back to shareholders and their hockable assets have little value in an economy which is rapidly changing.

Which brings me back to the last stanza of my poetic "mouseterpiece" where I point to "hope" as the flying

buttress of value in the marketplace. As long as a new generation of investors can be guiled into thinking that dividends are just around the corner for many of these stocks, then there will be "value" and stocks can rise. There may be few reasons to think that they can't, despite the valiant attempts of this bond prejudiced *Outlook* – with perhaps one large exception. The "future generation of players" which provides payment to the retiring generation, can do so most easily when the outgoing and incoming generations are roughly proportionate in size. But if a much larger outgoing generation (Boomers) at some point over the next 5-10 years demand payment in full for their shares, then the much smaller future generation of 30-40 year olds may not have enough collective money to pay for it, no matter how successful the "sting." The older the investor group then, (and U.S. investors will age rapidly as the chart above points out) the harder it becomes to sustain "value."

At some future point, "hope" will by necessity trade at a discount, P/Es will likely return to historical or less than historical averages, and higher dividend yields may once again represent perhaps the primary source of value for many stocks. Until then, stock investors should march carefully in this ticker tape charade.

Dow 5,000

Investment Outlook - September 1, 2002

Okay, so what's a bond guy doing talking about the stock market again? Shouldn't he stick to his "knitting?" Isn't he really just an equity transvestite in disguise? A frustrated stock wannabe who couldn't get a job in the early 1970's and took the best thing he could find - A Bond Manager? Yeah, well maybe, but then again maybe you owners and managers of stocks could benefit from a different perspective. We already "know" bonds are going to yield/return 5% or so over the next umptyump years. How about asking the same question for stocks? Afraid of the answer?

My message is as follows: stocks stink and will continue to do so until they're priced appropriately, probably somewhere around Dow 5, 000, S&P 650, or NASDAQ God knows where. Now I guess I'm on somewhat of a rant here but come on people get a hold of yourselves. Earnings have been phonied up for years and the market still sells at high multiples of phony earnings. Dividends and dividend increases have been miserly to say the least for several decades now and you've been hoodwinked into believing the CORPORATION should hold on to them for you so that they can convert them into capital gains and save you taxes. Companies have been diluting your equity via stock

options claiming that management needs incentives of millions of dollars just to get up in the morning and come in to work. Then they pick you off by trading on insider information, selling shares before the bad news hits and you have a chance to get out. If you try to get a hot IPO you fin all the shares are taken - by Bernie Ebbers. Come on stockholders of America, are you naïve, stupid, masochistic, or better yet, in this for the “long run?” Ah, that’s it, you own stocks for the “long run.” We bond managers may have had a few good relative years but who can deny Stocks for the Long Run?

Not Jeremy Siegel, not Peter Lynch, maybe not even Bill Gross if you stretch the time period long enough - 20, 30, 40 years. But short of that, stocks can be, and often have been poor investments. The return on them depends significantly on their beginning valuation and right now valuation remains poor. Dow 5, 000 is more reasonable. Let’s see why.

To present my case I resort to a panel of expert witnesses, academicians and financial theorists with a lot more brainpower than I have. Over the past several years, in contrast to the more bullish and optimistic Jeremy Siegel, or Jim Glassman of Dow 36, 000 fame, there have been several more realistic and down to earth experts that speak to low, not high, equity returns over the foreseeable future. Their primary thesis is not that the U.S. economy is headed for a depression or that the economic sky is falling but that even under near normal economic growth rates, the U.S.

stock market is priced at current levels to return less than has been historically "required." Grow those earnings they say (although let's be sure what they are) at near historic rates and you'll still need much lower prices in order to offer stock investors a chance at returns that exceed corporate bonds or even inflation protected Treasuries - TIPS. Many of you readers may be familiar with Peter Bernstein via his books on risk or even gold, but recently he teamed up with common sense and actuarial wizard Rob Arnott to produce a brilliant piece of research entitled What Risk Premium is Normal? In addition, the trio of Elroy Dimson, Paul Marsh, and Mike Staunton have written a book that may have equaled or perhaps surpassed Siegel's, as well as Ibbotson and Sinquefields' study of world wealth, with their Triumph of the Optimists, a 101-year survey of investment returns. I shall refer to both sets of authors frequently over the next few pages.

Let me say first of all that it is difficult to keep this simple. I've read, reread and near-memorized both of these research gems. Their contents seem simple to me now but they were not at the beginning, so I must assume the same for most of you. Besides, you have minutes not months to get my drift, and if I am to help you I must inform you quickly and yet simply, even leaving some critical think pieces out, in order to do so. Forward. The crux of the valuation argument is this:

Stocks historically return more than almost all other alternative investments but only when priced right when the race begins. If you star t from day one with P/E's too high or importantly, dividends too low, you will not obtain equity returns in excess of bonds. Seems simple enough. People know that if they pay twice the market price for their house, that it will take years and years to get their money or their equity out. Somehow though when it comes to stocks they forget.

Maybe they forget because it's hard to know at any point what a stock or a stock market should be worth. Here's some help. Jeremy Siegel, "DMS" (author's Dimson, Marsh and Staunton), as well as "B&A" (Bernstein and Arnott) all pretty much agree that over the past 100 years U.S. stocks have provided a real return (after inflation) of about 6.7%. While that return has been higher than for most other countries shown in the "DMS" chart below, in none of the countries did stocks fail to outperform bonds over the past century and that includes several stock markets, which virtually disappeared during WWI and WWII. The average real return for the 16 countries shown was 5.1%.

Remember that these returns are ex-inflation, so that arguments for higher nominal returns in inflationary periods and lower nominal returns during times of low inflation are neutralized.

Using the commonsensical approach that "100 years of the past" is "100 years of prologue" an investor might

reasonably expect to have future real returns come close to 6.7% in the U.S. and 5.1% globally. Remember though, to get those same returns with similar economic growth you have to start at the same valuation point as an investor did in 1900. Maybe the market was super cheap then and very expensive now. Makes a difference, and as you're about to find out, that was exactly the case. Although 1900's stock market would provide 6.7% real over the next century, turns out it was because of some reasons that you probably wouldn't think of right off the top of your noggin. Most investors would say it was because earnings grew that much, so stock prices just naturally followed like a little puppy dog at the heels of its master. Wrong. The two primary components of this 6.7% real return were 1) a beginning dividend yield of 4.2% and 2) rising valuation (P/E's going up). Real earnings growth, or its twin, real dividend growth, comes in a poor third. Over those same 100 years, real dividends managed to grow at only .6% as seen in the "DMS" chart below.

Ninety percent of the market's real return then came from factors other than earnings growth. Most of it came from the initial dividend yield.

And so dear reader, in an attempt to keep this simple and help you to plough through what can get most complicated, the primary element in determining how a stock market is priced - whether it's cheap or expensive - is its yield. At 4.2% in 1900, the market needed an additional

2.0% annual push from a tripling of P/E ratios over the century to get near that 6.7% real return. Earnings growth was a pathetically small factor. How could that be? As Peter Lynch said in a recent CNBC interview when asked about the future of the stock market, “Well, since WWII corporate profits have grown about 8 or 9 percent a year…I don’t see why that won’t be different the next 50 years, " implying that stock prices would do the same or more. The problem is, as Peter Bernstein points out in an August 2002 research piece entitled The Trouble With Earnings, at least 50% of the earnings growth over the past 40 years has been earnings of the “mystical” kind - pro forma, operating, phonied up. Those “earnings” didn’t flow through to dividends. In addition a goodly portion of Lynch’s 8-9 percent - and the faster portion it turns out - has come from newly created companies that are not even listed and available for purchase by outside investors. The balance after subtracting 4 percent inflation… has been near the .6% real growth of the past 100 years or the .8% of the past 50 years. You are being hoodwinked America. You pays your money and you gets…you gets…a dividend yield and a little bit of dividend growth: .6% real over the last 100 years.

Where does that leave us (you - not me - I’m out of the market) today? Well, most large market indices (NYSE, Wilshire 5000) yield somewhere in the area of 1.7%. Whoa now, did I say 1.7%? Yes siree. And despite the claims for higher implied yields due to stock buybacks (mostly

fallacious) even if we grant an “implied” yield of 2.0% to the market, it’s hard to see how we can get to our 6.7% real return target. Say real dividends grow at 2.0% for the next 100 years instead of .6%. Not sure why that would be but let’s just say that to be more than fair. If so, then a 2% implied dividend yield, plus 2% real dividend growth, only equals 4% - far short of our hoped for or perhaps required 6.7% of the past 100 years. How to get there? Well, absent faster economic growth which would lead to even higher dividend growth than I’ve already generously granted, the only way to make that happen is to start with a yield of 4.7% and the only way to do that would be to cut the market averages in half or more. Dow 4, 000 would do it as would S&P 400.

Now to be fair and truthful to B&A and DMS, both assert that the 6.7% real return over the past 100 years should never have been the “expected” return anyway. After all, 2.0% of that 6.7% came from a tripling of P/E ratios which is really not rational to expect again over the next century. A rather unscientific adjustment, which neither DMS nor B&A employ, would be to use the 100-year real return from equities without the tripling effect, or 4.7%. If so, with 2% real dividend growth, stock markets need to yield 2.7% and would fall by 20% in order to get there. At Dow 7, 000 or so we would be fairly priced.

B&A and DMS approach it a little differently though, using an historical “equity risk premium” to get to an appropriate

starting point valuation. This equity risk premium is really the excess return that investors require over and above real Treasury yields (best measured by TIPS yielding nearly 3.0%) to compensate them for the increased volatility and increased risk of owning stocks. Both B&A and DMS calculate that risk premium should be roughly 2.4% when measured against 30-year TIPS. Let me though, introduce my final chart that you can play with yourself. This chart's horizontal axis tracks the equity risk premium that you, the investor, would be satisfied with. Ask yourself this: *How much more real return over and above 30-year Government guaranteed TIPS do you need to compensate you for owning stocks?* If you say nothing, then the sky's the limit - Glassman theorized just this when writing Dow 36, 000. If however, you have some common sense and know that even over the long term there's a decent chance of something going haywire - war, depressions, deflation, etc. - then you'll need something more than the government guaranteed TIPS rate of 3.0% to buy stocks. B&A and DMS say it has been and should be an extra 2.4% in which case the DOW is worth 5, 000 on this chart. But put in your own number and see what value you get.

If you've got even half of your marbles left, I'll bet you your number is nowhere near today's level of 8, 500. That means that in order to get a real return sufficiently higher than 3.0% to meet your "risk premium" requirements the market has to go down before it can go up again. And when

it starts to go up again, it’s only going to produce inflation adjusted, real returns of 5% over the long run if it mimics what the market has returned over the past 100 years (absent a tripling of P/E ratios). Until then, stocks are losers and anyone who owns too many of them will be losers too. As Warren Buffett has said, in the short run the stock market is a voting machine but in the long run it’s a weighing machine. Despite being down nearly 50% from its highs, this market remains overweight. Forget about “Stocks for the Long Run” until they slim down to the point from which even yours truly can admit that they will outperform the bond market. And if some of this is confusing, just remember this: the market needs to yield close to 3.5% before it approaches fair value, and that means DOW 5, 000. While stocks are the best bet over the very long term, they will not be, nor will they beat bond returns until they begin the race from a fair valuation. Since in the short-term the stock market is a voting machine/popularity contest, it’s impossible to say exactly when, if ever, this fair valuation mark of approximately Dow 5, 000 will be reached. If it doesn’t get there however, future real equity returns will be lower than 5%, and a diversified portfolio of government, mortgage, and corporate bonds will be the best performing asset class for years to come. And oh, one large caveat. If the bond market continues to rally and the Fed can successfully engineer a 2% long-term TIPS rate instead of 3%, then stock markets are actually within 10% of fair

valuation. That, however, would continue to support the case for bonds as the better performing asset class. Sounds like an opening for a bond geek to write Bonds for the Long Run. Count me out - one book’s enough for me.

William H. Gross

The Hours

Investment Outlook - March 1, 2003

What happens when we die?
We go back to where we came from.

And where
is that? I
can't
remember.

- Dialogue from The Hours

One of the benefits of writing a book is that it serves as a snapshot of time. Thoughts, feelings, philosophies of living change as we funnel down through the hourglass and the printed word is near immutable proof of such transformations. One thing that strikes me about "me" as I infrequently pick up *Everything You've Heard About Investing Is Wrong* is how absorbed I was in my late forties and early fifties with religion and the meaning of life. My stories describing St. Catherine's Church and the fictional Father Guido Sarducci were numerous, and filled with frequent references to religion and the search for a higher authority. Nearly a decade later in 2003, I must confide that

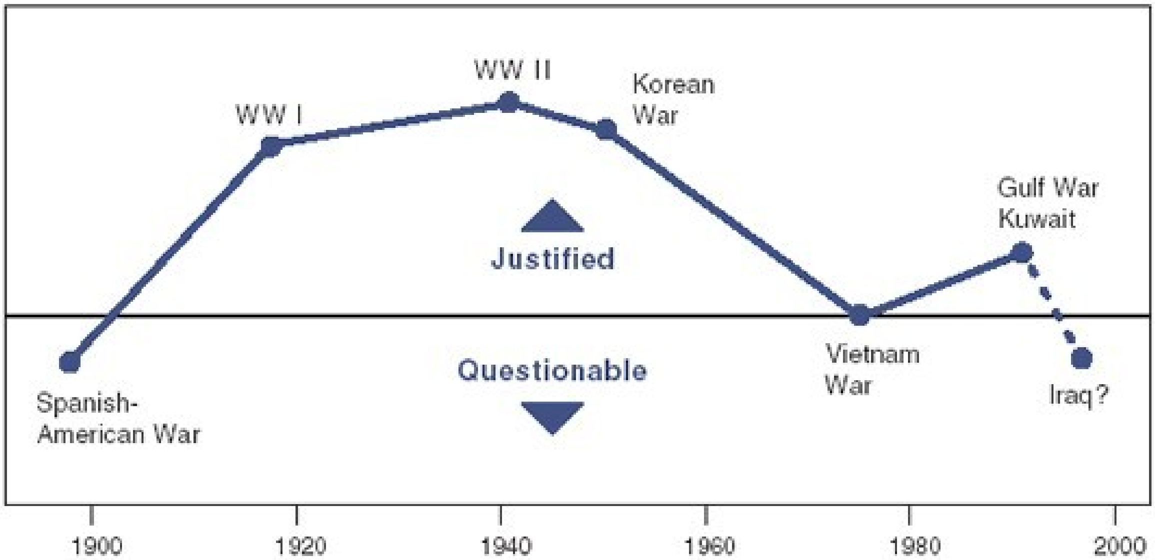
I am no nearer to resolving the conundrum. Like Virginia Woolf in *The Hours*, I cannot remember where I came from, and I lack certainty in where I am going. We have company - Virginia and I. Still there are those who have found answers to their individual quests and I accept their certitude if not their conclusions. In the absence of personal resolution, I fall back on the thinking of Tennyson: “There lives more faith in honest doubt, " he wrote, “than in half the creeds.” Perhaps. My life seems sprinkled with such self-consolations as the conclusion to my multi-act play comes rushing towards me faster than I care to acknowledge. And my current faith, if it could be described as such, would be a near resignation, suggesting that in the absence of certainty, the best we can do is to encircle our loved ones, display empathy and compassion to the billions that share a world with us, and hold on tight as we descend into the maelstrom. Answers, if any, await in the density of that great black hole beyond.

While I’m in the emoting mood let me tread into even more dangerous waters and speak to the impending conflict with Iraq. For those of you who have already had enough, please skip this paragraph and proceed to the actual investment outlook. I am not a geopolitical expert, but I have an opinion founded on what hopefully is a healthy dose of common sense and historical perspective. I speak now, and risk client, public, and press censure because I was silent 35 years ago. I sailed off to Vietnam, came back and collected my Veteran’s benefits and was none the

worse for the experience. But hundreds of thousands, including some friends - were - and that is the point I suppose, in speaking out now. The crux of the current argument involving Iraq is this: All would agree, especially since 9/11 that America has a right to defend herself. The question is how far we can go in that defense and in the process what cost to the American spirit and the American soul.

President Bush and others say that we must take almost every step to insure our internal safety. He argues that, in addition, those steps will bring positive changes in regimes dominated by oppression; Afghanistan, Iraq, North Korea and Iran are but steppingstones towards a new democratic world order with America at the center. I know the arguments - I'm even temporarily persuaded by them during emotional speeches such as Bush's State of the Union. I suspect, however, that by invading "evil doer" nations, we may lessen our vulnerability but lose a piece of our soul in the process. Yes, I'm aware that Iraq is in noncompliance with UN resolutions and that its leader is a near madman. I'm also aware, however, of how absolute power corrupts and how we may be crossing a thin line. Preemptive attacks? Kill them before they kill us? No one has experienced such Hours in the United States before. I am heartbroken that it has come to this and I fear for my country's proud heritage and even more for its future.

America's Wars – A Growing Bear Market



Source: Yours Truly.
This chart is not based on any statistical information and represents the current opinions of the manager.

And now finally, it is time for the investment Hour. Readers may remember my *Investment Outlook* remarks of recent months suggesting that the U.S. Treasury market's "salad days" are over. If short rates can't go down from here, then further price increases for intermediate and long-term Treasuries are unlikely, especially under the threat of accelerating fiscal deficits and Fed Governor Bernanke's vow to use any and all means to defeat deflation. "I believe him, " I suggested, and I still do. 2-4% inflation beginning in 2004 and continuing for at least several years beyond is the most likely outcome, which would seem to lead to an "overvalued" Treasury market. After all, if inflation a few years hence almost matches existing yields, then real

interest rates, at least for nominal as opposed to TIPS related Treasuries, are close to 0%. Overvalued indeed.

I have also cautioned, however, that just because a 20-year bull market in bonds is likely now complete, it is not necessarily the case that a new bear market has begun. 10-year Treasury yields at 4% do not exactly resemble “NASDAQ 5000.” I cite two primary reasons for this bear market “hibernation” of uncertain duration. First of all, it is important to remember that during our last secular transition from inflation to disinflation it took several years for intermediate and long-term yields to adjust. Return with me to the Volcker years of 1979-81 during which he vowed to raise short rates as high as necessary to reverse America’s inflationary spiral. He did - raise rates - eventually producing a prime of 20%+. He did - initiate a 20-year trend of disinflation - starting at a CPI peak of 14.8% in March of 1980 and culminating at an ebb of 1.2% in June of 2002. But it was not until mid-1984 that long-term bond investors began to catch on. 30-year Treasuries were still at 14% in June of that year. There is no reason to suspect anything different this time around in terms of the pace of secular transformation from “dis” to “re” inflation. It may take many more quarters of abysmally low short rates to begin to throw cold water in the face of bond investors used to a Caesar Salad and near double-digit annual total returns. In the meantime, Treasury yields could stay at overvalued levels, reflecting not only disbelief in the ability of the Fed

and the Congress to reflate, but the remarkably attractive "carry" during this sleepy time period of hibernation. With money market funds yielding less than 1%, a 4% Treasury undoubtedly has considerable appeal to some investors despite its downside price risk.

There is a second reason to suspect continued overvaluation in U.S. Treasuries. If current reflationary tactics do not gain traction, if 1% Fed funds and $300+ billion deficits do not sustain a satisfactory growth rate in nominal GDP, then Fed Governor Bernanke has hinted at using additional weapons in the Fed's arsenal. While those extraordinary measures are numerous, the bulk of Bernanke's "promises" center on the purchase of 1-year to perhaps 3-year Treasuries in order to "guarantee" a minimum return for holders over a future period of time. In the process, the Fed would presumably inject liquidity sufficient to reflate the economy. These tactics, which involve capping yields, at first blush appear to offer investors few favors, but the implicit promise of price stability allows for an extension of risk further out on the yield curve which would serve to limit the downside price risk of 10 to 30-year Treasuries as well. In addition, the mortgage market would continue to thrive, refis and equity takeouts would stimulate consumer spending, and the housing bubble, if real, would be granted a stay of execution. And if for some reason, 30-year fixed rate mortgage yields did not decline, Bernanke has hinted at the

possibility of outright purchases of GNMAs, which would accomplish the same thing. Like the movement of U.S. troops to the borders of Iraq in anticipation of an early March invasion, the Fed and the Treasury may have begun preparation to do just that in the GNMA market. The messiness of purchasing thousands upon thousands of small GNMA pools has been reduced by GNMA's recent lowering of the cost of what are known as "platinum" or mega- sized mortgage pools. The Fed, with just slight exaggeration, could now buy one trillion dollars of GNMAs and have but one accounting entry per month. Bernanke's war may not be imminent but the logistics are falling into place.

Typically, inflation is the primary driver of bond yields, and when the word "reflation" begins to characterize the outlooks of bond managers such as PIMCO, investors tend to fear the worst. I suspect however, a delay of bond market Armageddon until the U.S. and perhaps even the global economy regains sufficient traction to grow on its own - without the benefit of extraordinarily low interest rates or Bernanke's troops in reserve. A run on the dollar is perhaps the only substantial fly in this scenario's ointment. While total returns should approximate only a bond's coupon in 2003 (4- 5%), the imminent demise of bonds just as investors are beginning to love them, has been exaggerated. I still prefer an overvalued Treasury to an overvalued stock.

And so the Hours go ticking by: Hours to our individual deaths - Hours to the demise of a country's soul - Hours before our financial markets may be employed in a high stakes game of Bernanke poker. Like Virginia Woolf, I wish to remember where we came from. For now, I can at least remember where we have been, but a few years hence, a new world order filled with fresh, more virulent memories may mask the contentment of my first 58 years.

William H. Gross

“Bon” or “Non” Appétit?

Investment Outlook - July 1, 2009

Greed will come again. But for now, the trend is the other way and it promises to persist for a generation at a minimum.

Kill the umpire, ” the fan cried to open the 1996 baseball season in Cincinnati, and eight pitches later, the man behind the plate, John McSherry, was dead, all 320 pounds of him screaming for more and more oxygen to feed his spastic heart. He’d been killed by a billion molecules of sink-clogging, Drano-resistant cholesterol that fed on his coronary artery and sucked up his life’s blood like a vampire in the heat of the night. The next day Howard Stern had characteristically railed that the antidote was obvious. It was the same for all fat people: “DON’T EAT, ” he howled. As if the ump hadn’t known. The fact was, he couldn’t stop. He loved the taste of food – every sugary, fat-ladened, carbohydrated morsel. The first bite was a special ecstasy, as was the last, and everything in between. The man, it seemed, was a Cuisinart with four limbs.

Franz Kafka wove a tale 100 years earlier that was a mirror image of McSherry’s tragedy. His “A Hunger Artist” described a professional faster – a sideshow freak in 19th century Europe who attracted attention and spare coins by

withering away inside a wooden cage. The gapers marveled at his shriveled skeleton, stuck their hands through the bars to nudge his boney ribs, and awed at his resolve to starve himself to the precipice of self-extinction. “I always wanted you to admire my fasting, ” confessed the hunger artist, “but you shouldn’t have. The fact is, I have to fast, I can’t help

it. I couldn’t find the food I liked. If I had found it, believe me, I would have made no fuss and stuffed myself like you or anyone else.”

The juxtaposition: one man who couldn’t stop and another one who couldn’t start – eating, that is. Their stories, though, are really not about food, but life itself – what compels us to do what we do, what forces us to act or not to act, what makes us who we are: is personal behavior really beyond our control? Shakespeare would retort that the fault lies not in our stars, but in ourselves. On the other hand, who are we other than this amorphous, gelatinous blob of moving flesh and bone molded primarily without our input, first by DNA, and then by environment into the living person we know as ourselves? Are we all just walking Cuisinarts, or better yet, mobile computers with a consciousness? Modern science has progressed to the point of asking, “Can machines think?” and if they can, it might well ask the corollary, “Are people machines?” The fact is that sophisticated modern machines can do just about anything a human being can do. The difference between

"us" and "them" may only be our consciousness. We are "aware" whereas they are not. But if true, who wants to be a machine that simply knows it's a machine? Who wants to walk the Earth as a preprogrammed robot with no input or free will? **Unless the John McSherrys of the world can stop eating and the hunger artists can start, we might as well just turn out the lights.**

Our economy's lights, if not switched off in a rehash of the 1930's Depression, have certainly been dimmed in a 21st century version likely to be labeled the Great Recession. Much like John McSherry, U.S. and many global consumers gorged themselves on Big Macs of all varieties: burgers to be sure, but also McHouses, McHummers, and McFlatscreens, all financed with excessive amounts of McCredit created under the mistaken assumption that the asset prices securitizing them could never go down. What a colossal McStake that turned out to be. Now, however, with financial markets seemingly calmed and an inventory-based recovery in store for the balance of 2009, there is a developing optimism that we can go back to the lifestyle of yesteryear. PIMCO's driving thesis however, if not a juxtaposition, is succinctly described as a "new normal" where growth is slower, profit margins are narrower, and asset returns are smaller than in decades past based upon the delevering and reregulating of the global economy, which in turn should substantially inhibit the "gorging" of goods and services that we grew used to in decades past.

Forecasts based on econometric models inevitably miss these secular/structural breaks in historical patterns because it is impossible to quantify human behavior, and long-term trends involving risk-taking and in turn derisking are decidedly human in their origin. Bell-shaped curves with Gaussian/random distributions fail to anticipate that human beings do not make decisions by chance or independently of each other, but in many cases in reaction to one another. Humanity’s personal and social computers appear to be programmed that way. And so, instead of “normal” distributions, economists and investors must learn to be on the lookout for “black swans, ” and if not, then certainly “fat tails, ” which differ from the measurement of natural phenomena accepted in science. “New normals, ” flatter-shaped bell curves, and structural shifts in previously accepted standards become not only possible, but probable as human nature reacts to itself and its prior behavior. The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.

PIMCO and yours truly are not masters of the antithesis, a subjective approach which might derisively be called “crystal ball gazing, ” but we try to focus on what might be legitimate changes in the way economies and financial markets are affected by seemingly irrational or “non-normal” behavior and events. **The supersizing of financial leverage and consumer spending in concert**

with the politicizing of deregulation describes in fifteen words our most recent brush with irrational behavior and inefficient markets. Greed will come again. But for now, the trend is the other way and it promises to persist for a generation at a minimum. The fact is that American consumers have suffered a collapse in wealth of at least $15 trillion since early 2007. Global estimates are less reliable, but certainly in multiples of that figure. And when potential spenders feel less rich by that much, the only model one can use to forecast the future is a commonsensical one that predicts higher savings, lower consumption, and an economic growth rate that staggers forward at a new normal closer to 2 as opposed to 3½%. There's no magic in that number, and no model to back it up, just a lot of commonsense that says this is how people and economic societies behave when stressed and stretched to a near breaking point.

I was impressed this weekend by an article in the Op-Ed section of *The New York Times* by staff writer Bob Herbert. "No Recovery in Sight" was the heading and his opening sentence asked, "How do you put together a consumer economy that works when the consumers are out of work?" That is really all one needs to ask when divining our economy's future fortune. Unless an optimist can prescribe how to put Humpty Dumpty back together again and shuffle him/her back to work then there can be no return to an "old normal." As unemployment approaches 10%, what is less

well publicized is that the number of “underutilized” workers in the U.S. has increased dramatically from 15 to 30 million. Those without jobs, as well as those individuals who only work part-time and have become discouraged and stopped looking, total 30 MILLION people. The number is staggering.

Commonsensically, one has to know that many or most of these are untrained for the demands of a green-oriented, goods-producing future economy. Imagine a welding rod in the hands of an investment banker or mortgage broker and you’ll understand the implications quicker than any economist using an econometric model.

What this all means to you as an investor is near obvious as well. Unsurprisingly, what still can be modeled is the direct correlation of real profit growth to real economic growth, assuming a constant division of the “pie” between profits, labor and government. If long-term economic growth declines by 1½% then profit growth will as well. This, after settling at perhaps half of absolute peak profit levels of 2007, because of the rise of savings rates from 0 to 8% or higher. But to add to the woes of the investor class, one has only to observe that their share of the pie is shrinking. What does the General Motors example tell us all about the rebalancing of power between the investor class and the proletariat? What do trillion-dollar deficits and the recent reinitiation of PAYGO government programs tell you about the future of corporate tax rates? They’re headed higher. Do you really think that a national health care program can be

paid for with cost-cutting as opposed to tax hikes at insurance companies and benefit-paying corporations throughout all sectors of the American economy? The new normal will not be investor-friendly unless your forecasting dial is turned to “Pollyanna” or your intelligence quotient is significantly less than 100.

Investors who stuffed themselves on a constant diet of asset appreciation for the past quarter- century will now be enclosed in a cage featuring government-mandated, consumer-oriented fasting. “Non Appétit, ” not Bon Appétit, will become the apt description for the American consumer, and significant parts of the global economy, including the U.S. Because this is so, short-term policy rates will be kept low for longer than cyclical norms, and the outlook for risk assets – stocks, high yield bonds, and commercial and residential real estate will involve just that – risk. Investors should stress secure income offered by bonds and stable dividend-paying equities. Consumer Cuisinart consumption is a relic of the past.

The beginning portion of this Outlook *was adapted from an original in 1996. The subject matter is not about obesity anymore than it is about anorexia, but is a commentary on human will, why we do the things we do, and ultimately how human nature as well as mathematical models can describe economic and financial market outcomes.*

William H. Gross

Privates Eye

Investment Outlook - August 1, 2010

Not only growth but capitalism itself may be in part dependent on a growing population.

I write this month to condemn the inventor of the electronic “seeing eye” toilet. Yes, that’s right, I’m talking toilets here, doo-doo-stuff, some of which I hopefully won’t step in myself over the next few paragraphs. I know there must be more substantive and less objectionable topics to bring before you, but I have a sense that many of you join me in spirit if not common experience and so I devote this month’s *Outlook* to another trivial snippet emphasizing our joint humanity and sense of loss due to the recent disappearance of the hand flusher.

I don’t know where it is located exactly, but there’s an electronic eye in the plumbing of public toilets these days that can sense when you get up and down (or is it down and up) and are finally finished with your “business, ” if you get my drift. My doctor says a proctology exam is a necessary evil but cameras in toilets? Never having seen myself from this particular angle, it is particularly embarrassing to turn over the assignment to a camera and in effect say, “Snap away – see anything that doesn’t look right?” I figure if there’s an eye there, then there could also be a little voice

that says, “Have a seat, ” which of course I do, usually with much haste and a sense that I’d better get on with it before I attract a crowd.

It’s after the dirty deed is complete, however, that the real intrigue begins. Does it flush or doesn’t it? Only the computer chip knows for sure. Sometimes, though, after the paperwork has been filed, pants pulled up and an attempted getaway initiated – nothing happens. No flush. Well, what is one to do in such circumstances? You can’t just leave it there, you know. Sometimes when the toilet’s plugged and there’s no plunger like in European bathrooms, you can get out of there quick with conscience in tact, but only, of course, after checking to see that there’s no one else in the restroom who might be able to testify against you in court for being a non-flusher. With electronic eye toilets, however, the conscience is never clear and so you wave your hand in front of the camera, hoping to convince it by the breaking of light waves that someone really has used the toilet and that somehow it just forgot, or maybe the deposit was so minuscule that it just didn’t merit a flush. Hello in there! Having failed to trick it, however, the next step is to look for that little button in the back that you supposedly push in an emergency – sort of like a “break glass in case of fire” toilet equivalent. But think of all the billions of germs! At least with an old handle you could kick it with your shoe, hold up your arms like a doctor scrubbing for surgery and make an exit looking like you’re auditioning for a part on *ER*. Finally I

suppose you head for the door, all the while listening for the flush, the flush, that beautiful sound of the flush. I could have done it myself, you know, with a lot less hassle. Which is why I support a retreat to the old days, (not the backyard outhouse), but the good old-fashioned hand flusher. One push, and presto – you're good to go!

I really do have a serious message this month, an adjunct to the New Normal that will likely impact growth and financial markets for years to come. Our New Normal, to repeat ad nauseam, is predicated upon deleveraging, reregulation and deglobalization, all of which promote slower economic growth and lower inflation in developed economies while substantially bypassing emerging market countries that have more favorable initial conditions. In recent months, Mohamed El-Erian has added a developing corollary that emphasizes the lack of an appropriate policy response to what is a structural as opposed to a cyclical development, and you should read his frequently published op-eds for a more thorough analysis as well as those written by Jeffrey Sachs and others who are constructively suggesting a way back to the old normal.

That return journey will be all the more difficult to accomplish, however, because of demographics, an influence that much like gravity is hard to see but whose effect is all too powerful. Demographics – or in this case population growth – is so long term in its influence that economists and observers are inclined to explain the

functioning of economic society without ever factoring in the essential part that it plays in growth. Production depends upon people, not only in the actual process, but because of the final demand that justifies its existence. The more and more consumers, the more and more need for things to be produced. **I will go so far as to say that not only growth but capitalism itself may be in part dependent on a growing population.** Our modern era of capitalism over the past several centuries has never known a period of time in which population declined or grew less than 1% a year. Currently, the globe is adding over 77 million people a year at a pace of 1.15% annually, but slowing. Still, that's 77 million more mouths to feed, 77 million more pairs of shoes to make, 77 million more little economic units of demand – houses, furniture, cars, roads, oil – more, more, more. Capitalism, I would assert, thrives on more, more, and more, but not so well when there is less or an **expectation** of less. **This is not the Malthusian thesis, which maintained that at some point the world would run out of food to satisfy a growing population; it is an assertion that capitalism depends upon final demand and that if there ever comes a time when population growth slows, then the world's most efficient economic system will be tested.** If anything, my thesis is anti-Malthusian in its assertion that there will always be enough **production** to satisfy a

growing **population**, but perhaps not enough new **people** to sustain growing **production**.

Observers will point out, as shown in the following chart, that global population growth rates have been declining since 1970 with no apparent ill effects. True, until 2008, I suppose. The fact is that since the 1970’s we have never really experienced a secular period during which the private market could effectively run on its own engine without artificial asset price stimulation. The lack of population growth was likely a significant factor in the leveraging of the developed world’s financial systems and the ballooning of total government and private debt as a percentage of GDP from 150% to over 300% in the United States, for example. Lacking an accelerating population base, **all** developed countries promoted the financing of more and more consumption per capita in order to maintain existing GDP growth rates. Finally, in the U.S., with consumption at 70% of GDP and a household sector deeply in debt, there was nowhere to go but down. Similar conditions exist in most developed economies.

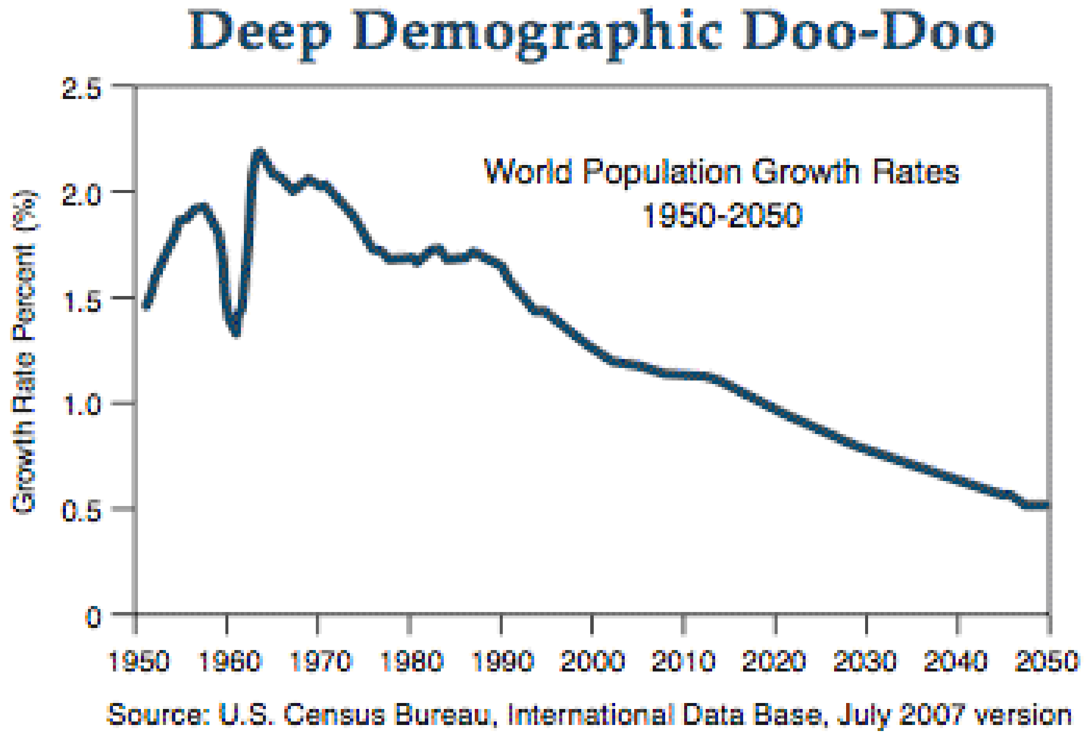


Chart 1

The danger today, as opposed to prior deleveraging cycles, is that the deleveraging is being attempted into the headwinds of a structural demographic downwave as opposed to a decade of substantial population growth. Japan is the modern-day example of what deleveraging in the face of a slowing and now negatively growing population can do. Prior deleveraging periods such as what the U.S. and European economies experienced in the 1930's exhibited a similar demographic with the lowest levels of fertility in the 20th century and extremely low population growth. Things did not go well then. Today's developed economies almost assuredly offer

substantially less population growth than the 1.5% rate experienced over the prior 50 years. Even when viewed from a total global economy perspective, population growth over the next 10–20 years will barely exceed 1%.

The preceding analysis does not even begin to discuss the **aging** of this slower-growing population base itself. Japan, Germany, Italy and of course the United States, with its boomers moving toward their 60s, are getting older year after year. Even China with their previous one baby policy faces a similar demographic. And while older people spend a larger **percentage** of their income – that is, they save less and eventually dissave – the fact is that they spend far fewer dollars per capita than their younger counterparts. No new homes, fewer vacations, less emphasis on conspicuous consumption and no new cars every few years. Healthcare is their primary concern. These aging trends present a one-two negative punch to our New Normal thesis over the next 5–10 years: fewer new consumers in terms of total population, and a growing number of older ones who don't spend as much money. The combined effect will slow economic growth more than otherwise.

PIMCO's continuing New Normal thesis of deleveraging, reregulation and deglobalization produces structural headwinds that lead to lower economic growth as well as half-sized asset returns when compared to historical averages. The New Normal will not be aided nor abetted by a slower-

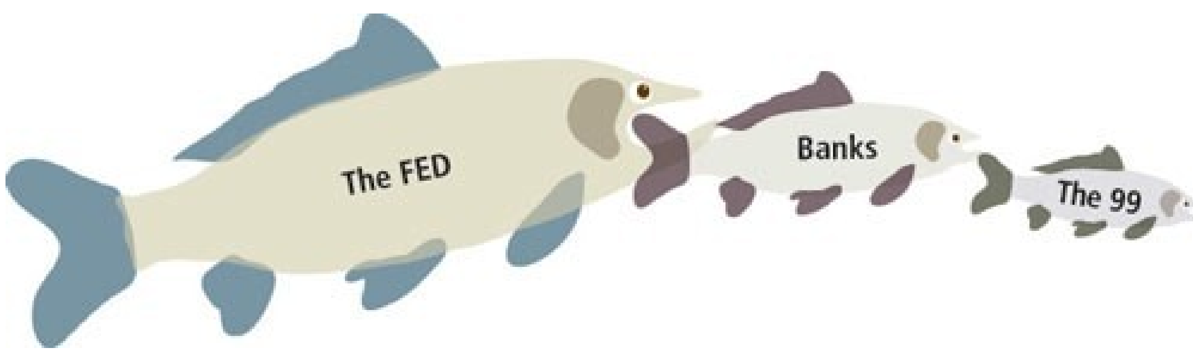
growing population nor by cyclical policy errors that thrust Keynesian consumption remedies on a declining consumer base. Current deficit spending that seeks to maintain an artificially high percentage of consumer spending can be compared to flushing money down an economic toilet. Far better to create and mimic other government industrial policies aimed at infrastructure, clean energy, more relevant education and less costly healthcare services. Until we do, policymakers will continue to wave their hands in front of the electronic eye – waiting for the flush, waiting for the flush, waiting for the flush, with very little success. Try another way, Washington. El-Erian, Sachs and other 21st century policy thinkers have a better way to push the handle.

William H. Gross

Wall Street Food Chain

Investment Outlook - June 1, 2012

The global monetary system may have reached a point at which it can no longer operate efficiently and equitably to promote economic growth and the fair distribution of its benefits.



The whales of our current economic society swim mainly in financial market oceans. Innovators such as Jobs and Gates are as rare within the privileged 1% as giant squid are to sharks, because the 1% feed primarily off of money, not invention. They would have you believe that stocks, bonds and real estate move higher because of their wisdom, when

in fact, prices float on an ocean of credit, a sea in which all fish and mammals are now increasingly at risk because of high debt and its delevering consequences. Still, as the system delevers, there are winners and losers, a Wall Street food chain in effect.

These economic and/or financial food chains depend on lots of little fishes in the sea for their longevity. Decades ago, one of my first Investment Outlooks introduced "The Plankton Theory" which hypothesized that the mighty whale depends on the lowly plankton for its survival. The same applies in my view to Wall, or even Main Street. When examining the well-known wealth distribution triangle of land/labor/capital, the Wall Street food chain segregates capital between the haves and have-nots: The Fed and its member banks are the metaphorical whales, the small investors earning .01% on their money market funds are the plankton. Yet similar comparisons can be drawn between capital and labor. We are at a point in time where profits and compensation of the fortunate 1% – both financial and non-financial – dominate wages of the 99% and the imbalances between the two are as distorted as those within the capital food chain itself. "Ninety-nine for the one" and "one for the ninety-nine" characterizes our global economy and its financial markets in 2012, with the obvious understanding that it is better to be a whale than a plankton. Not only do Wall Street and Newport Beach whales like myself have blowholes where they can express their

omnipotence as they occasionally surface for public comment, but they don't have to worry as yet about being someone else's lunch.

Delevering Threatens Global Monetary System Yet while the whales have no immediate worries about extinction, their environment is changing – and changing for the worse. **The global monetary system which has evolved and morphed over the past century but always in the direction of easier, cheaper and more abundant credit, may have reached a point at which it can no longer operate efficiently and equitably to promote economic growth and the fair distribution of its benefits.**

Future changes, which lie on a visible horizon, may not be so beneficial for our ocean's oversized creatures.

The balance between financial whales and plankton – powerful creditors and much smaller debtors – is significantly dependent on the successful functioning of our global monetary system. What is a global monetary system? It is basically how the world conducts and pays for commerce.

Historically, several different systems have been employed but basically they have either been commodity-based systems – gold and silver primarily – or a fiat system

– paper money. After rejecting the gold standard at Bretton Woods in 1945, developed nations accepted a hybrid based on dollar convertibility and the fixing of the greenback at $35.00 per ounce. When that was overwhelmed by U.S. fiscal deficits and dollar printing in the late 1960's, President Nixon ushered in a new, rather loosely defined system that was still dollar dependent for trade and monetary transactions but relied on the consolidated "good behavior" of G-7 central banks to print money parsimoniously and to target inflation close to 2%. Heartened by Paul Volcker in 1979, markets and economies gradually accepted this implicit promise and global credit markets and their economies grew like baby whales, swallowing up tons of debt-related plankton as they matured. The global monetary system seemed to be working smoothly, and instead of Shamu, it was labeled the "great moderation." The laws of natural selection and modern day finance seemed to be functioning as anticipated, and the whales were ascendant.

Too Much Risk, Too Little Return

Functioning yes, but perhaps not so moderately or smoothly – especially since 2008. Policy responses by fiscal and monetary authorities have managed to prevent substantial haircutting of the $200 trillion or so of financial assets that comprise our global monetary system, yet in the process have increased the risk and lowered the return of sovereign

securities which represent its core. Soaring debt/GDP ratios in previously sacrosanct AAA countries have made low cost funding increasingly a function of central banks as opposed to private market investors. QEs and LTROs totaling trillions have been publicly spawned in recent years. In the process, however, yields and future returns have plunged, presenting not a warm Pacific Ocean of positive real interest rates, but a frigid, Arctic ice-ladened sea when compared to 2–3% inflation now commonplace in developed economies.

Both the lower quality and lower yields of previously sacrosanct debt therefore represent a potential breaking point in our now 40-year-old global monetary system. Neither condition was considered feasible as recently as five years ago. Now, however, with even the United States suffering a credit downgrade to AA+ and offering negative 200 basis point real policy rates for the privilege of investing in Treasury bills, the willingness of creditor whales – as opposed to debtors – to support the existing system may soon descend. Such a transition occurs because lenders either perceive too much risk or refuse to accept near zero-based returns on their investments. As they question the value of much of the $200 trillion which comprises our current system, they move marginally elsewhere – to real assets such as land, gold and tangible things, or to cash and a figurative mattress where at least their money is readily accessible. “There she blows, ” screamed Captain

Ahab and similarly intentioned debt holders may soon follow suit, presenting the possibility of a new global monetary system in future years, or if not, one which is stagnant, dysfunctional and ill- equipped to facilitate the process of productive investment.

While all monetary systems are a balance between debtors and creditors, absent voluntary defaults, it is usually creditors that establish the rules for transitions to new regimes. Such was the case in the late 1960's as France's de Gaulle threatened to empty Ft. Knox unless a new standard was imposed. Now, with dollar reserves widely dispersed in Chinese, Japanese, Brazilian and other surplus nations, it is likely to assume that there will come a point where 2% negative real interest rates fail to compensate for the advantages heretofore gained in buying sovereign bonds. **China, for instance, may at the margin shift incremental Treasury holdings to higher returning commodity/real assets which might usher in a gradual or somewhat sudden reconfiguration of our current dollar-based credit system. Having a reduced incentive to purchase Treasuries and curtail Yuan appreciation, the Chinese and their act-alikes may look elsewhere for returns. In addition, previously feared but now tamed private market bond vigilantes like PIMCO have similar choices,**

if clients with their index-bounded holdings begin to broaden their guidelines. Together, there is the

potential for both public and private market creditors to effect a change in how credit is funded and dispersed – our global monetary system. What that will look like is conjectural, but it is likely to be more hard money as opposed to fiat-based, or if still fiat-centric, less oriented to a dollar-based reserve currency. In either case, the transition is likely to be disruptive and an ill omen for seafaring investors.

Reflationary Potential, Low Asset Returns

This transition continues to point towards higher global inflation as a solution to overextended debt-ladened balance sheets – be they public or private. Bond investors therefore should favor quality and "clean dirty shirt" sovereigns (U.S., Mexico and Brazil), for example, as well as emphasize intermediate maturities that gradually shorten over the next few years. Equity investors should likewise favor stable cash flow global companies and ones exposed to high growth markets. Investors in general, however, will be hard pressed to repeat the rather right-tailed performance of the past 30 years, a whale rather than plankton-dominated era based on excessive credit expansion. Deleveraging economies and financial markets present a different and lower returning kettle of fish than did recent credit-dominated decades.

That is because historical leverage was almost always applied by borrowing at a short-term rate and lending longer and riskier at a higher yield. That “spread” practically guaranteed levered returns over and above the policy lending rate during the past 30 years. No matter whether it was at 10%, 5% or eventually approaching 0% the lending spread at a higher yield was threatened only on a temporary basis during cyclical economic contractions brought about by temporary periods of tight money on the part of the Federal Reserve. As long as the economy bounced back, credit extension and its profitability were never threatened.

Figure 1 is a line graph of the 30-year U.S. Treasury yield from 1980 to 2012. The yield trends downward since roughly late 1981, when it peaks around 15%. By 2012, it’s around 3%, near its other low for the period shown, of just less than 3% around 2008.

Chart 1

Source: Bloomberg

All of that changed, however, as deleveraging produced narrower yield margins, asset price exhaustion, and a reluctance on the part of lenders to lend (and in many cases – borrowers to borrow). Combined with now negative real interest rates of 200–300 basis points on the front end of the lending curve, the ability to successfully <u>lever</u> financial market returns has been jeopardized. **Bond, equity and all financial assets which are structurally bound together by this dynamic must lower return expectations**. Maintain a vigilant watch matey!

Plankton Disappearing, Food Chain at Risk

The world's financial markets currently seem obsessed with daily monetary and fiscal policy evolutions in Euroland which form the basis for risk on/risk off days in the marketplace and the overall successful deployment of carry and risk strategies so important to asset market total returns. Euroland is just a localized tumor however. The developing credit cancer may be metastasized, and the global monetary system fatally flawed by increasingly risky and unacceptably low yields, produced by the debt crisis and policy responses to it. The great white whale lies waiting on the horizon. Investors should sail carefully and the Wall Street 1% should put on their life vests if they expect to weather the inevitable storm that may threaten the first-class cabins they have come to enjoy.

William H. Gross

Pimco’s Bill Gross on How to Play “Credit Supernova”

Wall Street’s Best Minds - January 31, 2013

Editor’s Note: Welcome to the first installment of a Barrons.com feature showcasing the written commentary of leading thinkers in money management and investment strategy. We hope you enjoy hearing from some of the best minds in investing.

They say that time is money. What they don’t say is that money may be running out of time.

Pimco co-founder Bill Gross

There may be a natural evolution to our fractionally reserved credit system which characterizes modern global finance. Much like the universe, which began with a big bang nearly 14 billion years ago, but is expanding so rapidly that scientists predict it will all end in a “big freeze” trillions of years from now, our current monetary system seems to require perpetual expansion to maintain its existence. And too, the advancing entropy in the physical universe may in fact portend a similar decline of “energy” and “heat” within the credit markets.

If so, then the legitimate response of creditors, debtors and investors inextricably intertwined within it, should logically be to ask about the economic and investment implications of its ongoing transition.

But before mimicking T.S. Eliot on the way our monetary system might evolve, let me first describe the “big bang” beginning of credit markets, so that you can more closely recognize its transition. The creation of credit in our modern day fractional reserve banking system began with a deposit and the profitable expansion of that deposit via leverage. Banks and other lenders don’t always keep 100% of their deposits in the “vault” at any one time – in fact they keep very little – thus the term “fractional reserves.” That first deposit then, and the explosion outward of 10x and more of levered lending, is modern day finance’s equivalent of the

big bang. When it began is actually harder to determine than the birth of the physical universe but it certainly accelerated with the invention of central banking – the U.S. in 1913 – and with it the increased confidence that these newly licensed lenders of last resort would provide support to financial and real economies.

Banking and central banks were and remain essential elements of a productive global economy.

But they carried within them an inherent instability that required the perpetual creation of more and more credit to stay alive. Those initial loans from that first deposit? They were made most certainly at yields close to the rate of real growth and creation of real wealth in the economy. Lenders demanded that yield because of their risk, and borrowers were speculating that the profit on their fledgling enterprises would exceed the interest expense on those loans. In many cases, they succeeded. But the economy as a whole could not logically grow faster than the real interest rates required to pay creditors, in combination with the near double-digit returns that equity holders demanded to support the initial leverage – unless – unless – it was supplied with additional credit to pay the tab. In a sense this was a “Sixteen Tons” metaphor: Another day older and deeper in debt, except few within the credit system itself understood the implications.

Economist Hyman Minsky did. With credit now expanding, the sophisticated economic model provided by

Minsky was working its way towards what he called Ponzi finance. First, he claimed the system would borrow in low amounts and be relatively self- sustaining – what he termed “Hedge” finance. Then the system would gain courage, lever more into a “Speculative” finance mode which required more credit to pay back previous borrowings at maturity. Finally, the end phase of “Ponzi” finance would appear when additional credit would be required just to cover increasingly burdensome interest payments, with accelerating inflation the end result.

Minsky’s concept, developed nearly a half century ago shortly after the explosive decoupling of the dollar from gold in 1971, was primarily a cyclically contained model which acknowledged recession and then rejuvenation once the system’s leverage had been reduced. That was then. He perhaps could not have imagined the hyperbolic, as opposed to linear, secular rise in U.S. credit creation that has occurred since as shown

in Chart 1. (Patterns for other developed economies are similar.) While there has been cyclical delevering, it has always been mild – even during the Volcker era of 1979-81.

When Minsky formulated his theory in the early 70’s, credit outstanding in the U.S. totaled $3 trillion. Today, at $56 trillion and counting, it is a monster that requires perpetually increasing amounts of fuel, a supernova star that expands and expands, yet, in the process begins to consume itself. Each additional dollar of credit seems to

create less and less heat. In the 1980's, it took four dollars of new credit to generate $1 of real GDP. Over the last decade, it has taken $10, and since 2006, $20 to produce the same result.

Minsky's Ponzi finance at the 2013 stage goes more and more to creditors and market speculators and less and less to the real economy. This "Credit New Normal" is entropic much like the physical universe and the "heat" or real growth that new credit now generates becomes less and less each year: 2% real growth now instead of an historical 3.5% over the past 50 years; likely even less as the future unfolds.

Not only is more and more anemic credit created by lenders as its "sixteen tons" becomes "thirty-two, " then "sixty-four, " but in the process, today's near zero bound interest rates cripple savers and business models previously constructed on the basis of positive real yields and wider margins for loans.

Net interest margins at banks compress; liabilities at insurance companies threaten their levered equity; and underfunded pension plans require greater contributions from their corporate funders unless regulatory agencies intervene. What has followed has been a gradual erosion of real growth as layoffs, bank branch closings and business consolidations create less of a need for labor and physical plant expansion.

In effect, the initial magic of credit creation turns less magical, in some cases even destructive and begins to consume credit markets at the margin as well as portions of the real economy it has created. For readers demanding a more model-driven, historical example of the negative impact of zero based interest rates, they have only to witness the modern day example of Japan. With interest rates close to zero for the last decade or more, a sharply declining rate of investment in productive plants and equipment, shown in Chart 2, is the best evidence. A Japanese credit market supernova, exploding and then contracting onto itself. Money and credit may be losing heat and running out of time in other developed economies as well, including the U.S.

Investment Strategy

If so then the legitimate question is: how much time does money/credit have left and what are the investment consequences between now and then? Well, first I will admit that my supernova metaphor is more instructive than literal. The end of the global monetary system is not nigh. But the entropic characterization is most illustrative. Credit is now funneled increasingly into market speculation as opposed to productive innovation. Asset price appreciation as opposed to simple yield or “carry” is now critical to maintain the system’s momentum and longevity.

Investment banking, which only a decade ago promoted small business development and transition to public markets, now is dominated by leveraged speculation and the Ponzi finance Minsky once warned against.

So our credit-based financial markets and the economy it supports are levered, fragile and increasingly entropic – it is running out of energy and time. When does money run out of time? The countdown begins when investable assets pose too much risk for too little return; when lenders desert credit markets for other alternatives such as cash or real assets.

REPEAT: THE COUNTDOWN BEGINS WHEN INVESTABLE ASSETS POSE TOO MUCH RISK FOR TOO LITTLE RETURN.

Visible first signs for creditors would logically be 1) long-term bond yields too low relative to duration risk, 2) credit spreads too tight relative to default risk and 3) PE ratios too high relative to growth risks. Not immediately, but over time, credit is exchanged figuratively or sometimes literally for cash in a mattress or conversely for real assets (gold, diamonds) in a vault. It also may move to other credit markets denominated in alternative currencies. As it does, domestic systems delever as credit and its supernova heat is abandoned for alternative assets. Unless central banks and credit extending private banks can generate real or at second best, nominal growth with their trillions of dollars,

euros, and yen, then the risk of credit market entropy will increase.

The element of time is critical because investors and speculators that support the system may not necessarily fully participate in it for perpetuity.

We ask ourselves frequently at PIMCO, what else could we do, what else could we invest in to avoid the consequences of financial repression and negative real interest rates approaching minus 2%? The choices are varied: cash to help protect against an inflationary expansion or just the opposite – long Treasuries to take advantage of a deflationary bust; real assets; emerging market equities, etc. One of our Investment Committee members swears he would buy land in New Zealand and set sail. Most of us can't do that, nor can you. The fact is that PIMCO and almost all professional investors are in many cases index constrained, and thus duration and risk constrained. We operate in a world that is primarily credit based and as credit loses energy we and our clients should acknowledge its entropy, which means accepting lower returns on bonds, stocks, real estate and derivative strategies that likely will produce less than double-digit returns.

Still, investors cannot simply surrender to their entropic destiny. Time may be running out, but time is still money as the original saying goes. How can you make some?

Position for eventual inflation: the end stage of a supernova credit explosion is likely to produce more inflation than growth, and more chances of inflation as opposed to deflation. In bonds, buy inflation protection via TIPS; shorten maturities and durations; don't fight central banks – anticipate them by buying what they buy first; look as well for offshore sovereign bonds with positive real interest rates (Mexico, Italy, Brazil, for example).

Get used to slower real growth: QEs and zero-based interest rates have negative consequences. Move money to currencies and asset markets in countries with less debt and less hyperbolic credit systems. Australia, Brazil, Mexico and Canada are candidates.

Invest in global equities with stable cash flows that should provide historically lower but relatively attractive returns.

Transition from financial to real assets if possible at the margin: buy something you can sink your teeth into – gold, other commodities, anything that can't be reproduced as fast as credit. Think of PIMCO in this transition. We hope to be "Your Global Investment Authority."We have a product menu to assist.

Be cognizant of property rights and confiscatory policies in all governments.

Appreciate the supernova characterization of our current credit system. At some point it will transition to something else.

We may be running out of time, but time will always be money. Speed Read for Credit Supernova

1. Why is our credit market running out of heat or fuel?
2. As it expands at a rate of trillions per year, real growth in the economy has failed to respond. More credit goes to pay interest than future investment.
3. Zero-based interest rates, which are the result of QE and credit creation, have negative as well as positive effects. Historic business models may be negatively affected and investment spending may be dampened.

Look to the Japanese historical example.

What options should an investor consider?

Seek inflation protection in credit market assets/ shorten durations.

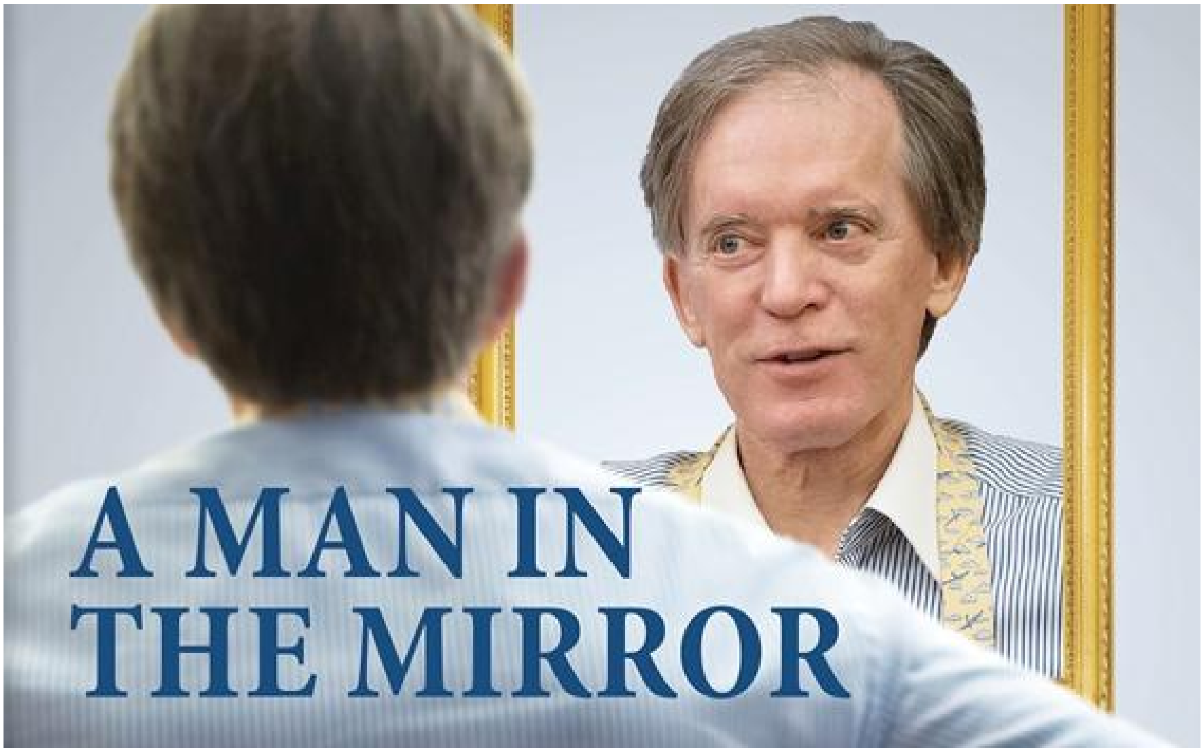
Increase real assets/commodities/stable cash flow equities at the margin.

Accept lower future returns in portfolio planning.

Gross is co-founder and managing director of Pimco.

A Man in the Mirror

Investment Outlook - April 3, 2013



I'm starting with the man in the mirror I'm asking him to change his ways

And no message could have been any clearer If you wanna make the world a better place

Take a look at yourself, and then make a... Chaaaaaaaange .....

— **Michael Jackson**

Am I a great investor? No, not yet. To paraphrase Ernest Hemingway's "Jake" in *The Sun Also Rises*, "wouldn't it be pretty to think so?" But the thinking so and the reality are

often miles apart. When looking in the mirror, the average human sees a six-plus or a seven reflection on a scale of one to ten. The big nose or weak chin is masked by brighter eyes or near picture perfect teeth. And when the public is consulted, the vocal compliments as opposed to the near silent/ whispered critiques are taken as a supermajority vote for good looks. So it is with investing, or any career that is exposed to the public eye. The brickbats come via the blogs and ambitious competitors, but the roses dominate one's mental and even physical scrapbook. In addition to hope, it is how we survive day-to-day. We look at the man or woman in the mirror and see an image that is as distorted from reality as the one in a circus fun zone.

Yet at first blush, there is a partial saving grace in the money management business. We have numbers. Subjective perceptions aside, we have total return and alpha histories that purport to show how much better an individual or a firm has been than the competition, or if not, what an excellent return relative to inflation, or if not, what a generous amount of wealth creation over and above cash … the comparisons are seemingly endless yet the conclusions nearly always positive, rendering the "saving grace" almost meaningless: everyone in their own mind is at least a six-plus or a seven, and if not for the most recent year, then over the last three, five, or 10 years. Investors thrive on the numbers and turn them in their favor when observing their

reflections. That first blush becomes a permanently rosy complexion with Snow White cheeks.

The investing public is often similarly deceived. Consultants warn against going with the flow, selecting a firm or an individual based upon recent experience, but the reality is generally otherwise. Three straight flips of the coin to “heads” produces a buzz in the crowd for another “heads, ” despite the obvious 50/50 probabilities, as do 13 straight years of outperforming the S&P 500 followed by … Well, you get my point. The *Financial Times* just published a study confirming that a significant majority of computer simulated monkeys beat the stock market between 1968 and 2011 – good looking monkeys that is.

In questioning initially whether I am a great investor, I open the door to question whether other similarly esteemed public icons like Bill Miller are as well. It seems, perhaps, that the longer and longer you keep at it in this business the more and more time you have to expose your Achilles heel

– wherever and whatever that might be. Ex-Fidelity mutual fund manager Peter Lynch was certainly brilliant in one respect: he knew to get out when the gettin’ was good. How his “buy what you know best” philosophy would have survived the dot-coms or the Lehman/subprime bust is another question.

So time and longevity must be a critical consideration in any objective confirmation of “greatness” in this business. 10 years, 20 years, 30

years? How many coins do you have to flip before a string of heads begins to suggest that it must be a two-headed coin, loaded with some philosophical/commonsensical bias that places the long-term odds clearly in a firm's or an individual's favor? I must tell you, after 40 rather successful years, I still don't know if I or PIMCO qualifies. I don't know if anyone, including investing's most esteemed "oracle" Warren Buffett, does, and here's why.

Investing and the success at it are predominately viewed on a cyclical or even a secular basis, yet even that longer term time frame may be too short. Whether a tops-down or bottoms-up investor in bonds, stocks, or private equity, the standard analysis tends to judge an investor or his firm on the basis of how the bullish or bearish aspects of the cycle were managed. Go to cash at the right time? Buy growth stocks at the bottom? Extend duration when yields were peaking? Buy value stocks at the right price? Whatever. If the numbers exhibit rather consistent alpha with lower than average risk and attractive information ratios then the Investing Hall of Fame may be just around the corner.

Clearly the ability of the investor to adapt to the market's "four seasons" should be proof enough that there was something more than luck involved? And if those four seasons span a number of bull/ bear cycles or even several decades, then a confirmation or coronation should take

place shortly thereafter! First a market maven, then a wizard, and finally a King. Oh, to be a King.

But let me admit something. There is not a Bond King or a Stock King or an Investor Sovereign alive that can claim title to a throne. **All of us, even the old guys like Buffett, Soros, Fuss, yeah – me too, have cut our teeth during perhaps a most advantageous period of time, the most attractive epoch, that an investor could experience.** Since the early 1970's when the dollar was released from gold and credit began its incredible, liquefying, total return journey to the present day, an investor that took marginal risk, levered it wisely and was conveniently sheltered from periodic bouts of deleveraging or asset withdrawals could, and in some cases, was rewarded with the crown of "greatness." **Perhaps, however, it was the epoch that made the man as opposed to the man that made the epoch.**

Authors Dimson, Marsh and Staunton would probably agree. **In fact, the title of their book "Triumph of the Optimists" rather cagily describes an epochal 101 years of investment returns – one in which it paid to be an optimist and a risk taker as opposed to a more conservative Scrooge McDuck.** Written in 2002, they perhaps correctly surmised however, that the next 101 years were unlikely to be as fortunate because of the unrealistic assumptions that many investors had priced into their markets. And all of this before QE and 0% interest

rates! In any case, their point – and mine as well – is that different epochs produce different returns and fresh coronations as well.

I have always been a marginal or what I would call a measured risk taker; decently good at interest rate calls and perhaps decently better at promoting that image, but a risk taker at the margin. It didn't work too well for a few months in 2011, nor in selected years over the past four decades, but because credit was almost always expanding, almost always fertilizing capitalism with its risk- taking bias, then PIMCO prospered as well. On a somewhat technical basis, my/our firm's tendency to sell volatility and earn "carry" in a number of forms – outright through options and futures, in the mortgage market via prepayment risk, and on the curve via bullets and roll down as opposed to barbells with substandard carry – has been rewarded over long periods of time. When volatility has increased measurably (1979-1981, 1998, 2008), we have been fortunate enough to have either seen the future as it approached, or been just marginally overweighted from a "carry" standpoint so that we survived the dunking, whereas other firms did not.

My point is this: PIMCO's epoch, Berkshire Hathaway's epoch, Peter Lynch's epoch, all occurred or have occurred within an epoch of credit expansion – a period where those that reached for carry, that sold volatility, that tilted towards yield and more credit risk, or that were sheltered either

structurally or reputationally from withdrawals and delevering (Buffett) that clipped competitors at just the wrong time – succeeded. Yet all of these epochs were perhaps just that – epochs. **What if an epoch changes? What if perpetual credit expansion and its fertilization of asset prices and returns are substantially altered?** What if zero-bound interest rates define the end of a total return epoch that began in the 1970's, accelerated in 1981 and has come to a mathematical dead-end for bonds in 2012/2013 and commonsensically for other conjoined asset classes as well? What if a future epoch favors lower than index carry or continual bouts of 2008 Lehmanesque volatility, or encompasses a period of global geopolitical confrontation with a quest for scarce and scarcer resources such as oil, water, or simply food as suggested by Jeremy Grantham? What if the effects of global "climate change or perhaps aging demographics, " substantially alter the rather fertile petri dish of capitalistic expansion and endorsement? What if quantitative easing policies eventually collapse instead of elevate asset prices? What if there is a future that demands that an investor – a seemingly great investor – change course, or at least learn new tricks? **Ah, now, that would be a test of greatness: the ability to adapt to a new epoch.** The problem with the Buffetts, the Fusses, the Granthams, the Marks, the Dalios, the Gabellis, the Coopermans, and the Grosses of the world is

that they'll likely never find out. Epochs can and likely will outlast them. But then one never knows what time has in store for each of us, or what any of us will do in the spans of time.

What I do know, is that, like Michael Jackson sang in his brilliant, but all too short lifetime, I am and will continue to look at the man in the mirror. PIMCO, Gross, El-Erian? – yes, we're lookin' good – in this epoch. If there's a different one coming though, to make our and your world a better place, we might need to look in the mirror and make a Chaaaaaaaange … Depends on what we see, I suppose. We will keep you informed.

Man in the Mirror Speed Read

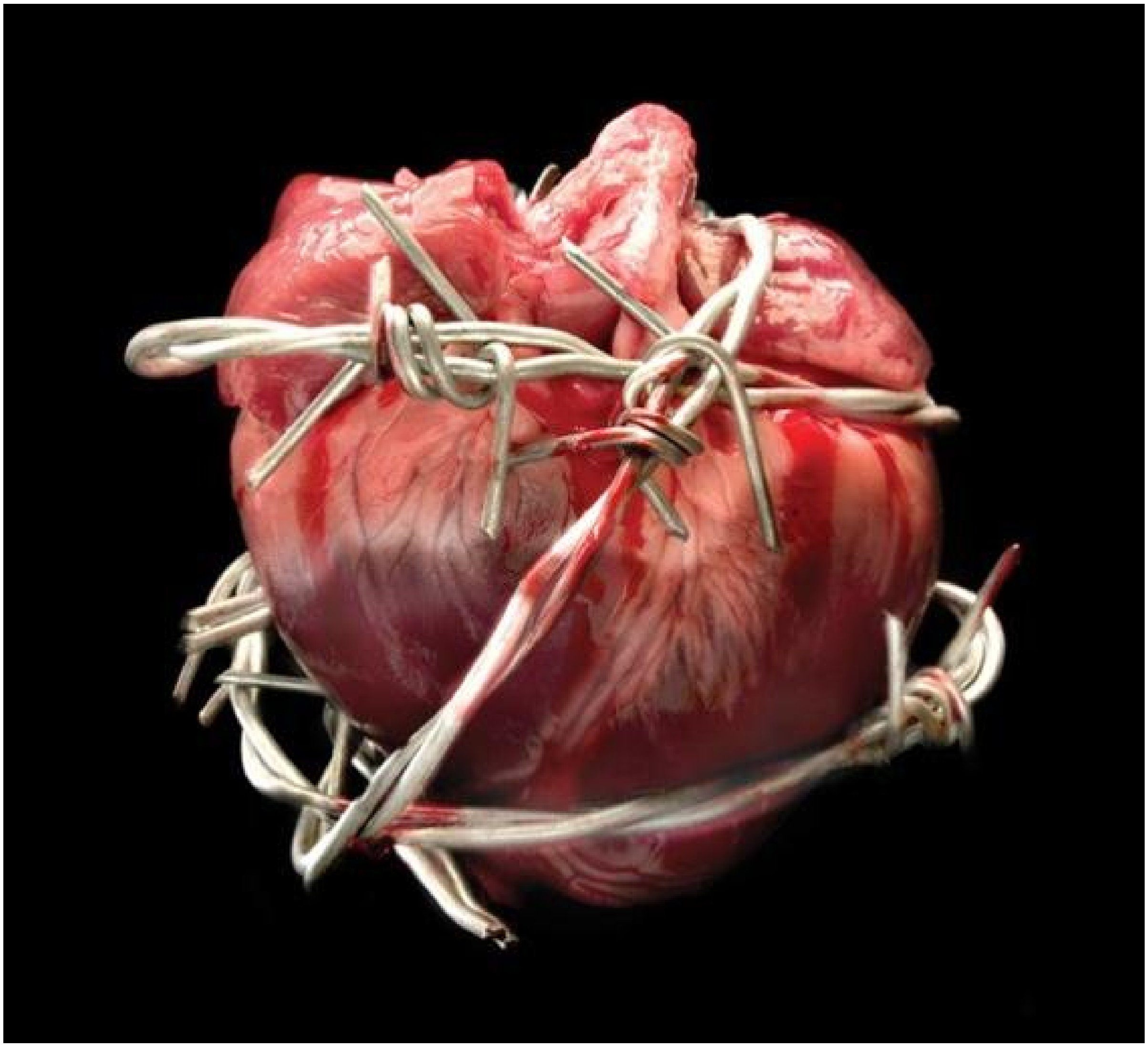
Investors should be judged on their ability to adapt to different epochs, not cycles. An epoch may be 40-50 years in time, perhaps longer.

Bill Miller may in fact be a great investor, but he'll need 5 or 6 more straight "heads" in a future epoch to confirm it. Peter Lynch is a "party pooper." Warren is the Oracle, but if an epoch changes will he and others like him be around to adapt to it?

No matter how self-indulgent you think this IO is, I just looked in the mirror and saw at least a 7. You must be blind!

Wounded Heart

Investment Outlook - June 4, 2013



Joseph Schumpeter, the originator of the phrase “creative destruction,” authored a less well- known corollary at some point in the 1930’s. “Profit, ” he wrote, “is temporary by nature: It will vanish in the subsequent process of

competition and adaptation." And so it has, certainly at the micro level for which his remark was obviously intended. Once proud, seemingly indestructible capitalistic giants have seen their profits fall short of "everlasting" and exhibited a far more ephemeral character. Kodak, Sears, Barnes & Noble, AOL and countless others have been "competed" to near oblivion by advancing technology, more focused management, or evolving business models that had better ideas more "adaptable" to a new age.

Yet capitalism at a macro level must inherently be different than the micro individual businesses which comprise it. Profits in total cannot be temporary or competed away if capitalism as we know it is to survive. Granted, the profit share of annual GDP can increase or decrease over time in its ongoing battle with labor and government for market share. But capitalism without profits is like a beating heart without blood. Not only is it profit's role to stimulate and rationally distribute new investment (blood) to the economic body, but the profit heart in turn must be fed in order to survive.

And just as profits are critical to the longevity of our capitalistic real economy so too is return or "carry" critical to our financial markets. **Without the assumption of "carry, " or return over and above the fixed, if mercurial, yield on an economy's policy rate (fed funds), then investors would be unwilling to risk financial capital and a capitalistic economy would die**

for lack of oxygen. The carry or return I speak to is most commonly assumed to be a credit or an equity risk "premium" involving some potential amount of gain or loss to an investor's principal. Corporate and high yield bonds, stocks, private equity and emerging market investments are financial assets that immediately come to mind. If the "carry" or potential return on these asset classes were no more than the 25 basis points offered by today's fed funds rate, then who would take the chance?

Additionally, however, "carry" on an investor's bond portfolio can be earned by extending duration and holding longer maturities. It can be collected by selling volatility via an asset's optionality, or it can be earned by sacrificing liquidity and earning what is known as a liquidity premium. There are numerous ways then to earn "carry, " the combination of which for an entire market of investable assets constitutes a good portion of its "beta" or return relative to the "risk free" rate, all of which may be at risk due to artificial pricing.

This "carry" constitutes the beating heart of our financial markets and ultimately our real economy as well, since profits on paper assets are inextricably linked to profits in the real economy, which are inextricably linked to investment and employment. Without these, the wounded heart dies and shortly thereafter the body. But there comes a point when no matter how much blood is being pumped through the

system as it is now, with zero-based policy rates and global quantitative easing programs, that the blood itself may become anemic, oxygen-starved, or even leukemic,

with white blood cells destroying more productive red cell counterparts. Our global financial system at the zero-bound is beginning to resemble a leukemia patient with New Age chemotherapy, desperately attempting to cure an economy that requires structural as opposed to monetary solutions. Let me shift from the metaphorical to the specific to make my case.

If "carry" is the oxygen that feeds financial assets then it is clear to all – even to central banks with historical models – that there is a lot less of it now than there used to be. In the bond market – interest rates, risk spreads, volatility and liquidity premiums are all significantly less than they were five years ago during the financial crisis and, in many cases, less than they have ever been in history. Before 2009, the U.S. had never had a policy rate so low, and in the U.K. short-term rates at 50 basis points are now nearly 2% lower than they have <u>ever</u> been, which is a long, long time. Throughout periodic depressions, the Bank of England in the 20th, 19th and even 18th century never dropped short rates below 2%. Add to that of course the New Age chemotherapy called Quantitative Easing (QE) being employed everywhere (and now in double doses at the Bank of Japan,) and you have an "all in", "whatever it takes" mentality that has

successfully lowered longer-term interest rates, risk spreads, volatility and risk premiums to similar extremes. Granted, the astute observer might counter that corporate and high yield risk "spreads" have historically been lower – and they were in 2006/2007 – but never have corporate and high yield bond "yields" been lower. Never has your average B/BB company been able to issue debt at well below 5% and never – which is my point – never have investors received less for the risk they are taking. "Never (as I tweeted recently) have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk."

In the process of reaching and stooping, prices on financial assets have soared and central banks have temporarily averted a debt deflation reminiscent of the Great Depression. **Their near-zero- based interest rates and QEs that have lowered carry and risk premiums have stabilized real economies, but not returned them to old normal growth rates. History will likely record that these policies were necessary oxygen generators.** But the misunderstood after effects of this chemotherapy may also one day find their way into economic annals or even accepted economic theory. **Central banks – including today's superquant, Kuroda, leading the Bank of Japan – seem to believe that higher and higher asset prices produced necessarily by more and more QE check writing will**

inevitably stimulate real economic growth via the spillover wealth effect into consumption and real investment. That theory requires challenge if only because it doesn't seem to be working very well.

Why it might not be working is fairly clear at least to your author. Once yields, risk spreads, volatility or liquidity premiums get so low, there is less and less incentive to take risk. Granted, some investors may switch from fixed income assets to higher "yielding" stocks, or from domestic to global alternatives, but much of the investment universe is segmented by accounting, demographic or personal risk preferences and only marginal amounts of money appear to shift into what seem to most are slam dunk comparisons, such as Apple stock with a 3% dividend vs. Apple bonds at 1-2% yield levels. Because of historical and demographic asset market segmentation, then, the Fed and other central banks operative model is highly inefficient. Blood is being transfused into the system, but it lacks necessary oxygen.

In addition, there are several other important coagulants that seem to block the financial system's arteries at zero-bound interest rates and unacceptably narrow "carry" spreads: Zero-bound yields deprive savers of their ability to generate income which in turn limits consumption and economic growth.

Reduced carry via duration extension or spread actually destroy s business models and real economic growth. If banks, insurance and investment management companies

can no longer generate sufficient "carry" to support employment infrastructures, then personnel layoffs quickly follow. With banks, net interest margins (NIM) are lowered because of "carry" compression, and then nationwide retail branches previously serving as depository magnets are closed one by one. In the U.K. for instance, Britain's four biggest banks will have eliminated 189, 000 jobs by the end of this year compared to peak staffing levels, reports Bloomberg News. Investment banking, insurance, indeed the entire financial industry is now similarly threatened, which is leading to layoffs and the obsolescence of real estate office structures as well which housed a surfeit of employees.

Zombie corporations are allowed to survive. Reminiscent of the zero-bound carry-less Japanese economy over the past few decades, low interest rates, compressed risk spreads, historically low volatility and ultra-liquidity allow marginal corporations to keep on living. Schumpeter would be shocked at this perversion of capitalism, which is allowing profits to be more than "temporary" at zombie institutions. Real growth is stunted in the process.

When ROIs or carry in the real economy are too low, corporations resort to financial engineering as opposed to R&D and productive investment. This idea is far too complicated for an *Investment Outloo*k footnote – it deserves expansion in future editions

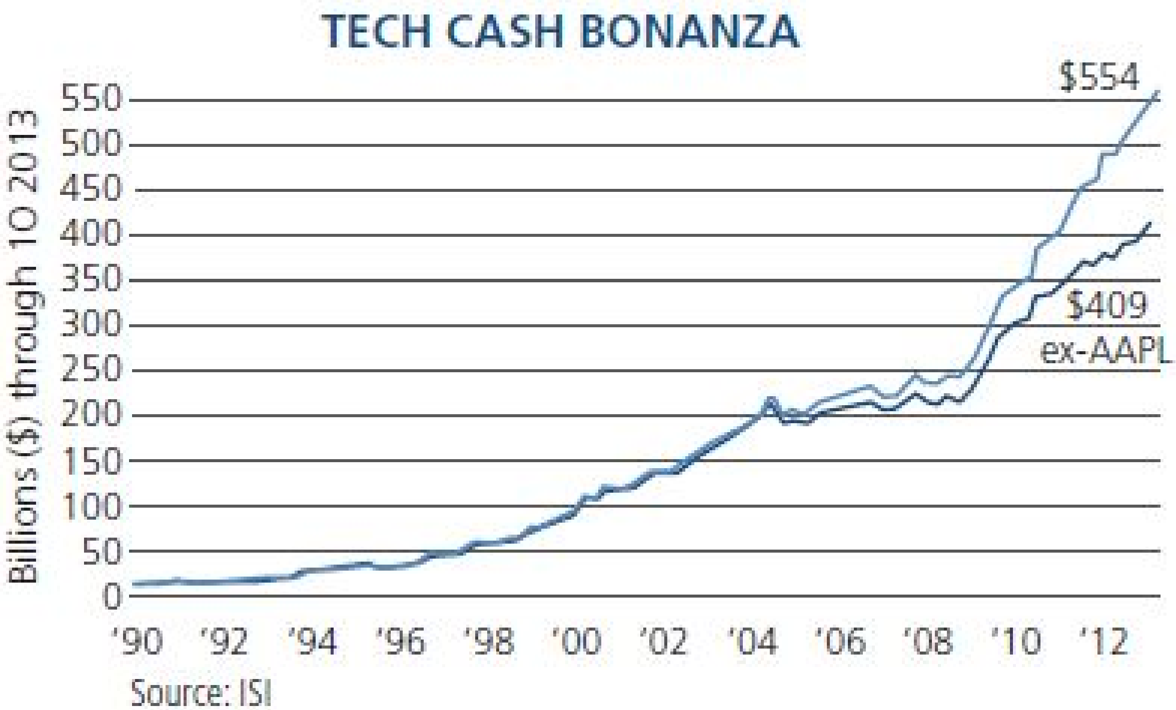


Chart 1

– but in the meantime, look at it this way: Apple has hundreds of billions of cash that is not being invested in future production, but returned via dividends and stock buybacks. Apple is not unique as shown in Chart 1. Western corporations seem focused more on returning capital as opposed to investing it. Low ROIs fostered by central bank policies in financial markets seem to have increasingly negative influences on investment and real growth.

Credit expansion in the private economy is restricted by an expanding Fed balance sheet and the limits on Treasury "repo." Again, too complicated for a sidebar *Investment Outlook* discussion, but the ability of private credit markets to deliver oxygen to the real economy is being hampered because most new Treasuries wind up in the dungeon of the

Fed’s balance sheet where they cannot be expanded, lent out and rehypothecated to foster private credit growth. I have previously suggested that the Fed (and other central banks) are where bad bonds go to die. Low yielding Treasuries fit that description and once there, they expire, being no longer available for credit expansion in the private economy.

Well, there is my still incomplete thesis which when summed up would be this: **Low yields, low** carry, future low expected returns have increasingly negative effects on the real economy. Granted, Chairman Bernanke has frequently admitted as much but cites the hopeful conclusion that once real growth has been restored to “old normal”, then the financial markets can return to those historical levels of yields, carry, volatility and liquidity premiums that investors yearn for. Sacrifice now, he lectures investors, in order to prosper later. Well it’s been five years Mr. Chairman and the real economy has not once over a 12-month period of time grown faster than 2.5%. **Perhaps, in addition to a fiscally confused Washington, it’s your policies that may be now part of the problem rather than the solution. Perhaps the beating heart is pumping anemic, even destructively leukemic blood through the system. Perhaps zero-bound interest rates and quantitative easing programs are becoming as much of the problem as the solution.** Perhaps when yields, carry and expected returns on financial and real

assets become so low, then risk-taking investors turn inward and more conservative as opposed to outward and more risk seeking. Perhaps financial markets and real economic growth are more at risk than your calm demeanor would convey.

Wounded heart you cannot save … you from yourself. More and more debt cannot cure a debt crisis unless it generates real growth. Your beating heart is now arrhythmic and pumping deoxygenated blood. Investors should look for a pacemaker to follow a less risky, lower returning, but more life sustaining path.

The Wounded Heart Speed Read

Financial markets require “carry” to pump oxygen to the real economy.

Carry is compressed – yields, spreads and volatility are near or at historical lows.

The Fed’s QE plan assumes higher asset prices will reinvigorate growth.

It doesn’t seem to be working.

Reduce risk/carry related assets.

How time in Navy, Vietnam shaped a budding billionaire's life

BY **CARLOS BONGIOANNI**

JULY 23, 2015

Republished courtesy of Stars and Stripes

Three years in the Navy during the Vietnam War was a good investment of time for billionaire Bill Gross.

Known as the “bond king” who founded the trillion-dollar global money management firm PIMCO, Gross cites his naval experience as the most formative time of his life — despite enduring some of his most humiliating failures and biggest blunders while serving from 1966 to 1969.

Gross said one particularly nerve-racking experience at sea was a “seminal moment” that shaped the way he did business for decades after serving.

“We were in the middle of the Pacific coming home from Vietnam,” Gross, 71, recalled recently in a telephone interview from his office in Newport Beach, Calif., where he now serves as portfolio manager at Janus Capital.

Gross was serving aboard the USS Diachenko, a 306-foot amphibious transport ship with a crew of about 120 sailors. Around 2 a.m., while standing the “midwatch,” he detected a large freighter heading straight toward their vessel.

As protocol required, he rang up the ship’s captain to inform him of the situation. The skipper, Lt. Cmdr. Sam Steed, whom Gross described as an “old salt in his 60s,” simply told his chief engineer to call later. After 10 minutes, Gross called again, reiterating to the captain in naval terms “contact constant bearing, decreasing range,” which meant the two ships were on a collision course.

Gross recalled how Steed finally left his quarters: “He staggers up in his skivvies, plops into the chair and grunts,

‘I’ve got the deck. I’ve got the con,’” meaning the skipper was at the helm in command of the ship.

It appeared to Gross that the two vessels were definitely going to collide, but since no orders were given to change course, Gross kept silent, figuring Steed knew what he was doing.

“He did nothing, and I did nothing. And it passed like 20 yards to the stern, about as close as you can get. And just as it’s passing, the captain wakes up and says, ‘What the F was that?’ It became apparent that he was asleep the whole time. … It was one of the most incredible things I’ve ever seen. We almost got sliced in half in the middle of the Pacific.”

Gross said he and the captain were “scared to death” and knew they would have been court-martialed if the ships had collided.

Though Gross calls the episode “the big mistake” of his life, he also views it as a significant learning moment. Junior officers bear responsibility for notifying superiors of exactly what’s going on — even if the superior is a gruff old salt who commands in his skivvies.

That experience, Gross said, taught him to speak up and to always communicate clearly, crisply, directly, immediately.

“That became the hallmark of how I did things,” he said.

For 35 years, Gross said that communication style worked well for him at PIMCO, where as chief investment

officer, he was essentially the captain of the ship. “To say what I thought, to make sure everyone understood me … We didn’t have any collisions, put it that way. We had lots of smooth sailing.”

But he said that style is now viewed as too blunt and abrasive by a new generation of young adults “raised to be soft and gentle, congenial and collegial.”

Gross left PIMCO in September 2014. According to a report in the New York Times, top executives grew tired of his leadership and management style, and Gross decided to exit the company he founded. In January 2015, Fortune magazine quoted Gross saying he was fired.

And just as it’s passing, the captain wakes up and says, ‘What the F was that?’ Bill Gross **Not all smooth sailing**After graduating from Duke University in May 1966, the 22-year-old psychology major had five months of free time before entering the Navy. With $200 to his name, Gross hopped a freight train from Durham, N.C., to Las Vegas to play blackjack. He had read a book about beating the odds and decided to try his luck at the game. In a few months, playing seven days a week, 16 hours a day, the soon-to-be Navy officer had amassed $10,000.

It sounds great, Gross said, but it worked out to be about $5 an hour. Gambling, he realized, was not so great in terms of return on investment. However, the principles he learned on beating the odds convinced Gross that his life’s work would take him into the investment world.

But first, he had an obligation to fulfill.

To honor the memory of a fraternity brother who joined the Marines and was killed in Vietnam six months after graduating from Duke, Gross decided he would join the military, too. The possibility of getting drafted also played into his decision to volunteer. In his senior year, Gross said another fraternity brother decided to become a Navy pilot. So Gross followed his friend’s lead, though he had never had a desire to fly.

By October 1966, Gross was in Pensacola, Fla., beginning an intense 12-week officer candidate school, which he likened to boot camp hell, with screaming, in-your-face drill instructors. One Marine drill sergeant bluntly told him that he’d never make it through flight school.

“He yelled at me in my face saying I’d never fly jets, that blimps were more my style,” Gross recalled.

It hurt, he said, but turned out to be the truth.

“I’m a conceptual person not a detail person,” Gross said. “The drill sergeant told me, ‘A conceptual pilot is a dead pilot.’ I think he was right. I just wasn’t comfortable in the air.”

Gross dropped out of Naval Flight School at Saufley Field in Pensacola in April 1967, after four months in the program.

“It was very humbling. I’d never been so scared in my life,” he recalled. “I remember going before the admiral, and he said ‘Son, we’ve spent $500,000 on you already. If you think you’re going to a plush assignment somewhere in the

Mediterranean you’ve got another thing coming. I’m sending you to Vietnam on an amphibious ship and making you ultimately the chief engineer.’ I saluted and said, ‘Yes sir.’”

He said ‘Son, we’ve spent $500,000 on you already. If you think you’re going to a plush assignment somewhere in the Mediterranean you’ve got another thing coming.’ Bill Gross **‘The shock of responsibility’**Gross, sent to Philadelphia for a crash course on damage control, chuckled at the thought of becoming a damage control officer — the first step in becoming a chief engineer. The five weeks of training, geared toward those who washed out of other programs, was barely long enough to scratch the surface on the subject, he said.

USS Diachenko (APD-123) underway, location unknown, circa 1966-67. U.S. NavyThe Diachenko was in dry dock in Bremerton, Wash., when the “scared 23-year-old kid,” as Gross referred to himself, reported for duty in June 1967. The young ensign would later realize that joining the ship in dry dock was a good way to learn the ropes of Navy life and to get integrated into the ship’s command system before it set sail for the Philippines four months later.

Gross was “like a fish out of water,” said Dennis Devitt, who was the ship’s chief engineer. “He was a very bright fellow … but you could tell he wasn’t destined to be in the Navy as a career officer,” he said by telephone from his Lakewood, Calif., home, where he is a retired lawyer. “He

just didn’t seem enthusiastic about being in the engineering department. He didn’t choose to be on the Diachenko in the surface Navy. He was there because he didn’t make it through the air program.”

Having grown up in Navy communities with a father who was a naval supply officer, Devitt said he had an advantage because of all the Navy exposure he had, including cruises aboard Navy ships as a teen. That wasn’t the case for Gross, whom Devitt noted was at a further disadvantage because he didn’t get the full complement of engineering training that other officers received.

By the time the ship hit the water to sail, Gross had been a commissioned officer for almost a year and no experience at sea.

Gross recalled being on the open seas heading to the Philippines as the junior officer on the deck with Devitt, who had command.

Devitt left the area, Gross recalled, announcing “‘Mr. Gross has the deck. Mr. Gross has the con.’ I didn’t know anything about taking the deck, taking the con, not even about giving a command, right rudder or anything. … It was just the shock of responsibility. I had 110, 120 people. Their lives were now my responsibility.”

Though Devitt said he didn’t remember the episode, he said he must have had some faith in Gross, because he never would have left the bridge while serving as the senior

watch officer without ensuring the person taking charge was properly qualified.

From damage control officer, Gross eventually became chief engineer. He took no comfort when the executive officer took him aside for a pep talk, saying, “Whatever you do here will be the forerunner for the rest of your life.”

Gross cringed, knowing his mechanical aptitude was minimal, and his knowledge of the ship’s innards — the boilers and machinery — was virtually nonexistent. “I wasn’t meant to be a chief engineer, but the necessities of war meant I would be,” he said. “I did the best I could.”

That Gross went on to make a name for himself is gratifying to Devitt, who said that a hospital in his area has a huge portrait in honor of Gross and his wife, Sue, for their generous donations. “I’m happy for his success. When I see that portrait, I’m thinking, ‘Bill used to work for me. I taught him everything he knows.’”

Transporting SEALS While Gross served on the Diachenko, the ship made four 60-day deployments to Vietnam from Subic Bay in the Philippines, where it received repairs and supplies while in port.

Gross was among a handful of officers who would captain one of four smaller boats attached to the Diachenko. The 30-foot boats were used primarily for surveying purposes to assess the depth of water at the mouth of rivers or at spots leading to possible beach landing sites along the coast of Vietnam.

The USS Diachenko enters San Diego harbor after completing her second tour in Vietnam in April 1967. U.S. NavyThe boats also carried SEALS who would roll off and swim to land for combat operations. Typically, the SEALS would return to the waiting boat six to eight hours later for a lift back to the mother ship patrolling about 10 miles offshore.

On his first SEAL-transport mission, Gross was stunned at what unfolded when 15 SEALS went ashore shortly after leaving his boat. An innocuous-looking group of Vietnamese was on the beach. The presence of women made it very deceptive, Gross said. “At least I never expected there to be hostile action with women on the beach. … As it turned out they were not peaceful villagers at all. They were Viet Cong.”

Gross said he watched from 100 yards offshore as one woman took off her broad-rimmed manila hat and placed it over her heart, which the SEALS informed him later was the signal to attack. When the grenade she had hidden in the hat exploded, all hell broke loose.

With only a handgun, Gross couldn’t do much. He radioed the skipper of the Diachenko to keep him apprised of the situation and made sure his boat did not run aground as he waited for the SEALS to return, which they did about an hour later.

Though he said he was nervous on his first SEAL transport, he initially thought it would be a “relatively safe

type of mission." That it wasn't made him all the more jittery for the other dozen or so SEAL-transport missions. "I was nervous all the time. I'd hear a sound and duck and get down."

Gross said he saw hostile action three times while transporting SEALS. For him, those were like the terrifying battle scenes out of the movie "Apocalypse Now," only he was on a boat with no mounted guns.

Gross is conflicted about his naval involvement off the coast of Vietnam.

On the one hand, he stressed how proud he is of his three years of military service. His time in the Navy, having to take responsibility even when he felt unqualified to do so, prepared him well for his work as an investment manager, he said. And the lessons he learned on always speaking up and maintaining clear channels of communication were vitally important in his civilian career.

"If I hadn't gone in and did what I did [in the Navy], none of this here [in his investment world] would have happened," he said.

On the other hand, Gross expressed guilt by association for those killed in the firefights he witnessed. He never pulled the trigger and never went ashore in combat, but he transported others who did.

"I wish … it had gone differently," he said in a halting whisper of a voice. "I wish … I wish …." Gross started and

stopped several times as if searching for the right words, as if weighing whether he should say what he was thinking.

"I wish we hadn't gone there in the first place."

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